Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1654

CONSUMER FEDERATION OF AMERICA,
ENERGY POLICY TASK FORCE,

*Petitioner,*

v.

FEDERAL REGULATORY ENERGY
COMMISSION.

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE
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October Term, 1977

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CONSUMER FEDERATION OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI
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FOR THE FIFTH CIRCUIT

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Consumer Federation of America's Energy Policy Task Force ("EPTF") */ petitions this Court to issue a writ

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*/ EPTF is a broad based coalition of over 50 major national consumer organizations, labor unions, farm groups, urban-based organizations, public power associations, and rural electric cooperatives, concerned with national energy matters.

of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

## OPINIONS BELOW

The opinion of the court of appeals (App. A., infra, pp. 1a-10a) is reported at 566 F.2d 536. Order 539-B of the Federal Power Commission is reproduced in Appendix B, infra, pp. 11a-29a.

## JURISDICTION

The judgment of the court of appeals was entered on January 20, 1978. An application for an extension of time within which to file a petition for a writ of certiorari, to and including May 20, 1978, was granted on April 23, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## QUESTIONS PRESENTED

1. Whether the Federal Energy Regulatory Commission is precluded by the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act from enforcing, in accordance with an appropriate standard, the delivery obligations under certificates of public convenience and necessity issued to producers of natural gas pursuant to Section 7 of the Act.

2. Whether the "prudent operator standard" constitutes a proper measure for enforcing delivery obligations under certificates of public convenience and necessity.



## STATUTES INVOLVED

Sections 1(b), 7(b), 7(c) and 7(e) of the Natural Gas Act, 15 U.S.C. § 717(b), § 717f(b), § 717f(c), and § 717f(e), are, in relevant part, reproduced in Appendix C, infra, pp. 30a-32a.

## STATEMENT

The opinion of the Fifth Circuit in this litigation is the subject of two petitions for certiorari -- the instant one and a petition being filed by the Federal Energy Regulatory Commission in Federal Energy Regulatory Commission v. Shell Oil Company, et al. The petitions relate to Order 539-B (App. B, infra, p. 11a), issued by the Commission's predecessor, the Federal Power Commission ("Commission"), as a statement of policy and standards governing the enforcement of natural gas delivery obligations certificated by the Commission under Section 7 of the Natural Gas Act, 15 U.S.C. § 717f.

The issuance of Order 539-B and the judicial review of that Order sought by both industry and petitioner Energy Policy Task Force, arise in a context unprecedented in the history of natural gas regulation. From the passage of the Natural Gas Act in 1938 until only a few years ago, the primary focus of Commission regulation had been on the price consumers would pay for gas transported in interstate commerce. The adequacy of supply was never really an issue; in fact, the market for natural

gas was a buyer's market. */ Since the late 1960s, however, the primary problem has been a growing shortage of natural gas, **/ and the major challenge for the Commission now lies in assuring the fulfillment of preexisting delivery obligations and the devising of measures to allocate a dwindling supply among competing uses. A corollary to the growing shortage is the fact that, for the first time, there is a substantial incentive for producers not to deliver all the gas available from their fields, but rather to sell their gas in the unregulated intrastate market or to conserve their supplies in hopes that

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*/ Federal Power Commission, National Gas Survey, Vol. I, p. 114 (1975).

**/ See, e.g., Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283, 331 (1974); Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621, 626 & n.2 (1972); Pacific Gas & Electric Co. v. Federal Power Commission, 506 F.2d 33, 35 (D.C. Cir. 1974); Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Federal Regulation and Regulatory Reform, H.R. Doc. No. 95-134, 94th Cong., 2d Sess. 385-388 (1976). See also FPC Staff Report No. 2, National Gas Supply and Demand 1971-1990 (1972): "The emergence of a natural gas shortage during the past two years marks an historic turning point -- the end of
(footnote continued)



deregulation, or Commission action on rates, will raise the price they can charge for interstate sales. */

In order to assist in dealing with the problems of dwindling supplies, and amidst increasing allegations of intentional withholdings of interstate deliveries for diversion to the intrastate market, the Commission enunciated its policy with respect to the enforcement of certificated obligations by issuing Order 539 on October 14, 1975.

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(footnote continued)
natural gas industry growth uninhibited by supply considerations." Id. at xi.

*/ Reflective of the growing shortage and the general incentive created by the disparity between interstate and intrastate rates are computations contained in a June 1977 FPC Bureau of Natural Gas Staff Report, entitled "Report of Monthly Curtailments Based on FPC Form No. 17," which shows that cumulative firm curtailment in the interstate market has grown from 17,535,000 Mcf in 1970 to 3,181,903,600 Mcf in 1976. Id., Schedule II, Sheets 2-4. Similarly, the interstate market's share of new reserve additions, reported by the American Gas Association, has fallen precipitously, while the intrastate market's share has increased dramatically. Thus, in 1966, 68% of the reserve additions were dedicated to the interstate market; by 1975, that
(footnote continued)

40 Fed. Reg. 49571 (October 23, 1975). */ There, the Commission stated that it had been and continued to be the Commission's policy:

> to enforce all deliverability and supply obligations of jurisdictional natural gas producers and jurisdictional natural gas pipelines, as they may be occasioned by applicable regulations of the Commission and the statutory standards of the Natural Gas Act, which govern -- and, therefore, which are incorporated within -- the certificates for all certificated arrangements authorized pursuant to the Act. Id. at 49571, col. 2.

In so doing, the Commission made it clear that its certificates imposed obligations on natural gas companies

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(footnote continued)
figure had fallen to 13%, with the remaining 87% dedicated to the intrastate market. FPC Opinion No. 770-A, November 5, 1976, at 116.

*/ For Congressional inquiries regarding fulfillment of delivery obligations, see Order 539, fn. 1. Id.



extending beyond the terms of individual contracts between producer and pipeline. Id., at 49572, col. 2.

To aid it in carrying out this policy, the Commission in Order 539 added a new section, § 2.83, to the General Policy and Interpretations in Title 18 of the Code of Federal Regulations. In subsection (a) of § 2.83, the Commission stated:

> [n]atural gas companies . . . shall comply with all deliverability or production of natural gas requirements to meet, inter alia, certificated operations, services, developments, quantities, volumes, or sales. Id., at 49573, col. 3 (emphasis added).

Subsection (d) of § 2.83 then set forth specific terms to be included in all future certificates, imposing on the certificate holder the obligation to report the results of any reserve determination or redetermination, and clearly stating that the producer had a "certificated minimum delivery obligation" to be determined by reference to the contract provision, as modified by the certificate, and to remain in force unless a change were authorized by the Commission, based upon the certificate holder's documentation to the Commission of the reasons for the change. Id., at 49573, col. 1.

The issuance of Order 539 brought forth a storm of protest from the producers, in the form of applications for rehearing and reconsideration. As a result, the Commission issued Order 539-A on March 26, 1976. 41 Fed. Reg. 14531 (April 6, 1976). While defending the position enunciated in Order 539, the Commission began to retreat significantly from its previous position on delivery obligations, shifting its focus from the Natural Gas Act and the certificates issued thereunder, to the private contract entered into between the producer and the pipeline. Thus, the Commission stated that in its earlier Order 539, it:

> intended to inform the parties to gas sales contracts that once deliveries under such contracts, as certificated by the Commission, commence in interstate commerce, such deliveries continue without unjustifiable unilateral interruption in accordance with the applicable provisions of the contract. Id., at 14532, col. 1. */ (Emphasis added.)

The Commission also gave notice of a rulemaking proceeding and hearing, designed to gather information con-

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*/ See also similar characterization at 14531, col. 3.



cerning the obligation of "parties accepting a certificate of public convenience and necessity from this Commission," and of its intention to amend § 2.83 accordingly. Id., at 14533, col. 1.

Both the industry and EPTF participated at the proceeding, through written comments and testimony. The producers argued, inter alia, that efforts by the Commission to enforce delivery obligations would run afoul of the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b), and that the underlying sales contracts placed no firm delivery obligations on producers. EPTF urged the Commission to return to the policy initially enunciated in Order 539 -- that certificate obligations take precedence over contract obligations -- and to measure the certificate obligation either by the level of service actually provided in the past or as defined by representations made at the time of application for a certificate.

Following the oral argument, the Commission, on July 30, 1976, issued Order 539-B to "clarify" its prior orders. (App. B, infra, pp. 11a, 11b.) Despite the fact that the notice of rulemaking provided by Order 539-A had indicated a purpose simply to "amend" § 2.83 of the Commission's General Policy and Interpretations, Order 539-B repealed that section entirely, including the reporting and approval requirements found in § 2.83(d). (App.

B, p. 22a.) In its place, the Commission enacted a new section -- § 157.41 -- of its regulations. (App. B., p. 23a.)

With this abrupt change, the Commission abandoned entirely the approach set forth in § 2.83 which focused upon the Commission's certification itself; instead the Commission essentially endorsed the contract between the producer and pipeline as establishing the contours of certificated obligations, while modifying those privately negotiated terms by the incorporation of a further contract concept -- "prudent operation." In describing the resultant nature of certificated obligations, the Commission stated:

> Once deliveries have commenced under the certificate, as conditioned, the responsibility for the development and maintenance of gas reserves underlying the committed acreage rests with the producer, and the applicable standard by which to judge whether a producer is properly proceeding with these obligations will be the above referenced "prudent operator standard." (App. B., p. 17a.)

The Order further stated that the prudent operator standard was adopted not because it reflected producer service obligations stemming from the certificates but essentially because it was a standard with which producers were "acquainted," through their own private lease arrangements and the regulation of certain state and federal agencies. (App. B, p. 17a.)



On the date Order 539-B was issued, Shell Oil Company petitioned for review of the Commission's orders in the Fifth Circuit, and other producers promptly followed suit. EPTF filed a timely motion to intervene in the Fifth Circuit and also applied to the Commission for reconsideration and modification of Order 539-B. After rehearing was denied, EPTF filed a petition for review in the Court of Appeals for the District of Columbia Circuit, which was subsequently transferred to the Fifth Circuit.

The matter was fully briefed by the producers, EPTF, and the Commission before the Fifth Circuit and oral argument was held on July 6, 1977. On January 20, 1978, the Fifth Circuit issued its opinion, declaring Order 539-B's "prudent operator" standard invalid, as contravening the jurisdictional exemption for production and gathering activities contained in Section 1(b) of the Act. Although recognizing that, under prior holdings of this Court, the Commission clearly has jurisdiction to "enforce 'service obligations' contained in certificates that it issues to producers [in order to prevent] producers from ceasing deliveries from fields . . . capable of continuing production" (App. A., p. 7a),

the court concluded:

> Order 539-B clearly is intended to open the door to [Commission] involvement into forbidden production activities. . . . To hold that the power to issue Order No. 539-B is within the jurisdiction of the [Commission] would all but eliminate the "production and gathering" exclusion and would allow the [Commission] to encroach on areas reserved to the states. (App. A., p. 10a.)

In so holding, the court of appeals did not reach the challenges to Order 539-B posed by EPTF, nor did it explain how the Commission might effectively exercise its admitted certificate enforcement powers.

## REASONS FOR GRANTING WRIT

This petition for certiorari and that filed by the Federal Energy Regulatory Commission pose important issues relating to the interpretation of the Natural Gas Act involving, in particular, the nature of the certificated obligations of natural gas companies and the jurisdiction of the Commission, in light of the "production and gathering" exemption in Section 1(b) of the Act, to enforce those obligations. Seen more broadly in the context of the current energy shortage, this case presents a crucial question of national



importance, with far-reaching economic implications.

Consumers -- individual users and industrial and business firms -- have a critical and justified reliance upon the continued flow of natural gas. As a 1975 Commission report pointed out, "the events of the past year have illustrated in dramatic and unmistakable terms the alarming degree to which this Nation's economic and social welfare are dependent upon assured and adequate energy supplies." */ Over "84 percent of the U.S. population lives in communities served with gas." **/ Industry, too, relies heavily on natural gas -- due to major investments of capital, pollution-control considerations and, in some cases, the lack of a suitable substitute fuel. ***/ In short, a nation-wide network of interrelated obligations, investments and economic and social well-being has developed upon the continued supplies of natural gas committed to the interstate market pursuant to the certificates of convenience and necessity issued by the Commission. While this network is not

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*/ Federal Power Commission, National Gas Survey, Vol. I, p. 6 (1975).

**/ Homeowners' investment in gas appliances alone exceeds $20 billion. Id. at 50.

***/ Id. Industrial uses account for 68.9 percent of total natural gas
(footnote continued)

immutable, and must adapt to the realities of diminishing supplies, that reliance interest must be protected to the extent it is based on already dedicated reserves. */

Regardless of whether available and presently certificated volumes of natural gas are being intentionally withheld from the interstate market, in hopes of deregulation or in response to the blandishments of the intrastate market, the existence of a shortage poses unique challenges to the regulatory scheme envisioned by the Natural Gas Act, and especially to the Commission if it is to fulfill its obligation under the Act to protect the consuming public from the self-interested actions of natural gas companies. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

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(footnote continued)
consumption in 1972. Id. at 38.

*/ It is important to note that the question of enforcement of existing delivery obligations will not be eliminated if the natural gas deregulation proposals currently being considered by Congress become a reality. The proposal most recently put before the House and Senate natural gas conferees provides for phased deregulation of new gas preceded by guaranteed price increases tied to inflation, with (footnote continued)



The Commission seemed to recognize the importance of this challenge when it enunciated its enforcement policy in Order 539, with its reporting provisions and firm requirement of Commission approval for deliveries failing to fulfill certificated obligations. With the subsequent issuing of Orders 539-A and 539-B, however, the Commission retreated from its original approach and adopted a standard that is based essentially upon a contractual concept unrelated to the certification process, and that is so vague as to be unenforceable. As a result, the Commission has managed since the onset of the natural gas shortage to mount only one meaningful enforcement effort, */ and remains

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(footnote continued)
additional annual escalators. Thus, subject to certain exemptions, already dedicated gas reserves would remain under regulatory price controls, at least until 1985 and, accordingly, such dedicated supplies would continue as an important source of lower priced gas for current consumers. House and Senate Natural Gas Conference, "Compromise Natural Gas Pricing Proposal" (May 3, 1978).

*/ See Gulf Oil Corporation v. Federal Power Commission, 563 F.2d 588 (3d Cir. 1977), cert. denied, 46 U.S.L.W. 3520 (February 21, 1978). The potential results of concerted enforcement efforts (footnote continued)

without an effective program for ensuring fulfillment of the delivery obligations it certificates. Essential to such a program are firm, clearly articulated standards, grounded in the concept of service under the Act, with adequate procedures for assuring Commission ability to focus limited resources on potentially non-complying activity. These are the features missing from Order 539-B and their absence, along with the accompanying jurisdictional question, warrant the grant of certiorari here.

1. Central to the Natural Gas Act's charge to the Commission "to protect consumers against exploitation at the

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(footnote continued)
are well demonstrated by events following the Gulf enforcement action. During the four-month period November 1976 through February 1977, Gulf's deliveries fell short of its certificated obligations by over 16,000,000 Mcf, as had been true for several prior years. Yet, following vigorous enforcement by the Commission, Gulf delivered 6,250,000 Mcf in excess of its certificate obligations during the 12 months from April 1977 through March 1978. Gulf Oil Corporation, Supplemental Statement Reflecting Refund and Interest, Docket No. CI 64-26, filed May 3, 1978 with the Federal Energy Regulatory Commission.



hands of natural gas companies," */ is the power to grant, deny and enforce certificates of public convenience and necessity, 15 U.S.C. § 717f. This Court has termed the certificate the "heart" of the Act, because it is a prerequisite to the transportation of natural gas in interstate commerce and the sale of natural gas for resale in the interstate market. Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, 388 (1957); 15 U.S.C. §§ 717, 717f.

The Commission is authorized to issue a certificate only if it finds that the applicant is "able and willing properly to do the acts and to perform the service proposed . . . ," 15 U.S.C. § 717f(e). As part of its application for a certificate, the producer submits its pipeline sales contract, along with various data bearing upon its anticipated level of service, 18 C.F.R. §§ 157.23-157.25. The pipeline contracting for the gas submits similar information, as well as detailed data on estimates of reserves and deliverability, 18 C.F.R. § 157.14. Following the issuance of a certificate by the Commission, the Act clearly states that there shall be no reduction in -- or abandonment of -- service without the approval of the Commission. 15 U.S.C. § 717f(b).

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*/ Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 610
(footnote continued)

The primacy of the certificate over private contractual rights, and the certificate's focus on service, have been repeatedly recognized by this Court. Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 152 (1960); Sun Oil Co. v. Federal Power Commission, 364 U.S. 170 (1960); Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378 (1959). See also Mitchell Energy Corp. v. Federal Power Commission, 533 F.2d 258 (5th Cir. 1976); Michigan Consolidated Gas Co. v. Federal Power Commission, 283 F.2d 204, 214 (D.C. Cir. 1960), cert. denied, 364 U.S. 913 (1960). */ Yet, despite this case law

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(footnote continued)
(1944). See also Federal Power Commission v. Texaco, Inc., 417 U.S. 380, 397-98 (1974); Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283, 321 (1974).

*/ In one of the earlier decisions on this subject, the Third Circuit explicitly rejected a company's arguments that abandonment was automatically justified by the operation of an escape clause in the certificated contract, stating:

> " . . . and most important, service to the public was the foundation of the contract operation. That service was given. The public has relied on it through the years and

(footnote continued)



and numerous references to the concept of continuing service as the justification for the terms of Order 539-B (App. B., pp. 13a, 15a, 16a), the standard of "prudent operation" actually proposed in that Order is wholly devoid of any concept of service. Indeed, in describing the operation of the "prudent operator" standard itself, the Commission makes no further mention of "service." (App. B., pp. 16a-18a.)

Equally as disturbing as this failing is the course of action followed by the Commission in arriving at the "prudent operator" standard. Having dismissed the producer contention that their contracts with the pipelines contain no firm obligations but permit them virtually unfettered control over the deliverability of natural gas (App. B., pp. 13a, 13b), the Commission did not proceed to a more careful examination of typical contracts, in order to extract some common denominator. */

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(footnote continued)

> is entitled to its fair continuance. To abandon it there must be Commission approval." (Emphasis added.)

J.M. Huber Corp. v. Federal Power Commission, 236 F.2d 550, 558 (3rd Cir. 1956), cert. denied, 352 U.S. 971 (1957).

*/ To the contrary, at least on the face of the Orders, the Commission by and

(footnote continued)

Nor did it examine the certification process to see what guidance the various undertakings or submissions there might provide in defining "certificated obligations." Instead, the Commission reached outside the certification process, drawing the concept of "prudent operation" from private lease agreements and state law. Having identified the circumstances in which this concept had been used, the Commission simply concluded that the standard was appropriate because "all producers are acquainted" with it (App. B., p. 17a). In so doing, the Commission seriously strayed from its proper role of construing existing certificate obligations, both explicit and implied. */ See Sunray Mid-Continent Oil Co. v. Federal Power Commission, supra; Sun Oil Co. v. Federal Power Commission, supra.

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(footnote continued)
large contented itself with abiding by the producers' characterization of their contractual obligations. See, e.g., the discussion in Order 539-B regarding "minimum daily delivery obligations," where the Commission simply stated, with reference to the producer response, "we must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers." (App. B., p. 12a).

*/ Moreover, the standard seems particularly inappropriate, since it is (footnote continued)



2. Given the present severe gas shortage and the conflicting demands such a shortage places on scarce supplies, the need for precise, definite standards and an assured enforcement mechanism are critical. Otherwise, consumers and natural gas companies alike will be at a loss to understand their rights and obligations. Unfortunately, the "prudent operator" standard fails to meet this test and thus runs afoul of the appropriate standard of "reasonableness." Placid Oil Co. v. Federal Power Commission, 483 F.2d 880, 888-89 (5th Cir. 1973), aff'd sub nom, Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283 (1974); Shell Oil Company v. Federal Power Commission, 520 F.2d 1061, 1070-71 (5th Cir. 1975), cert. denied, 426 U.S. 941 (1976). See also Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). In the process, it similarly fails to provide an appropriate mechanism to assist the Commission in its task of protecting consumers' interests. Federal Power Commission v. Hope Natural Gas Co., supra.

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(footnote continued)
derived primarily from lessor-lessee contract law where it was designed to protect the lessor's private pecuniary interests.

The fluid nature of this "reasonableness" standard is apparent on its face, and is underscored by the few illustrative factors identified by the Commission in Order 539-B, e.g., performance requirements in the lease arrangement, valid state law, and prudent practice (App. B, p. 17a). And, if anything, the origins of the standard will only tend to confuse the matter further. The Commission admitted as much in the court of appeals where it said that "due to public interest considerations," it could not enforce "exactly the prudent operator standard used by a lessor or purchaser . . ." Brief of Respondent Federal Power Commission, at p. 25. In summary, we submit, a more workable standard, comprehensible to the regulated and the beneficiaries of regulation alike, is mandated by the Act. */

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*/ This seems particularly so, when an alternative approach, more consistent with the Act's requirements, can be readily developed. Such a system would, as indicated by Sunray and later decisions of this Court, focus on service provided, as amplified by, inter alia, the contract underlying the certificate and the submissions made at the time of application. It would be accompanied by an adequate reporting system, with a mechanism to assure Commission approval of declining deliveries. Recognition both of the inevitable decline in production, and the short
(footnote continued)



3. The producers broadly assert that Section 1(b) of the Natural Gas Act (App. C., p. 30a) bars Commission enforcement of certificated delivery obligations. See, e.g., Order 539-B, App. B., 20a; Order 539-A, supra, 41 Fed. Reg. at 14581, col. 3. */ While the Fifth Circuit declined to accept this claim (App. A., p. 7a), its opinion nevertheless casts a pall over the authority of the Commission to implement an enforcement policy. This fact is reason enough for the granting of certiorari in this case. While we do not address the issue of the Commission's jurisdiction to enforce delivery obligations under a "prudent operator" standard, we do submit that past decisions of this Court should leave little doubt as to the authority of the Commission to require compliance with appropriate standards governing those

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(footnote continued)
term swings, would of course be a necessary part of the system which, incidentally, would appear to be quite similar to that envisioned by § 2.83 of Order 539 -- the order initially issued by the Commission.

*/ Indeed, as indicated above, many producers also argue that they have retained total delivery discretion under their contracts, thus on the basis of contract terms at least, leaving the Commission with no ascertainable obligations to enforce. See p. 19, supra.

obligations. */ United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965); Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954). See also Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

In considering this question, it is critical to note the enormous investments made by natural gas pipelines to transport gas in interstate commerce. These investments are made in light of delivery contracts with producers and pursuant to the certificates issued by the Commission, based upon the detailed information submitted by pipelines, and behind them, by the producers. The pipelines in turn contract with distributors, setting in motion an elaborate system of investments, and reliance upon natural gas deliveries, terminating in end use by the individual consumer or industrial establishment. To deny the Commission the authority to enforce producers' certificated delivery obligations would be to pull the underpinnings from this extensive network, and in the process, to seriously

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*/ At the same time, we note that the standard proposed by EPTF less directly implicates production and gathering activities than does the "prudent operator" standard, although some impact upon production and gathering is perhaps inevitable in the enforcement of producers' delivery obligations.



inhibit the underlying purpose of the Natural Gas Act. Similarly, to delay a firm resolution of this matter, knowing the producers' position on the jurisdictional question and in light of the negative impact of continued uncertainty upon the Commission's regulatory activity, would seem inappropriate.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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## APPENDIX A

**SHELL OIL COMPANY et al., Petitioners,**

**v.**

**FEDERAL ENERGY REGULATORY COMMISSION, Respondent.**

**No. 76-3066, Et Al.**

United States Court of Appeals,
Fifth Circuit.

Jan. 20, 1978.

On petition of natural gas producers for review of a Federal Energy Regulatory Commission order, the Court of Appeals, Tjoflat, Circuit Judge, held that the specific statutory exclusion of "the production and gathering of natural gas" from FERC jurisdiction prohibited FERC from issuing Order No. 539-B, which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves, and FERC could not use the power to issue certificates to extend its jurisdiction into the excluded area.

Vacated and remanded.

**1. War and National Emergency ⇐305**

The specific statutory exclusion of "the production and gathering of natural gas" from the jurisdiction of the Federal Energy Regulatory Commission prohibited FERC from issuing Order No. 539-B, which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves, and

1. Order No. 539-B, — F.P.C. —, 41 Fed.Reg. 32,883 (1976), establishes 18 C.F.R. § 157.41 (1977), which provides:

FERC could not use the power to issue certificates to extend its jurisdiction into the excluded area. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

**2. War and National Emergency ⇐303**

Natural gas producers are subject to the jurisdiction of the Federal Energy Regulatory Commission when they engage in activities that can be classified as sales or transportation rather than as production or gathering. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

**3. War and National Emergency ⇐305**

The Federal Energy Regulatory Commission can enforce "service obligations" contained in the certificates that it issues to natural gas producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

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Petitions for Review of Orders of the Federal Power Commission.

Before CLARK, RONEY and TJOFLAT, Circuit Judges:

TJOFLAT, Circuit Judge:

Shell Oil Company and other natural gas producers bring this petition to review the Federal Energy Regulatory Commission's (FERC) Order No. 539–B, —— F.P.C. ——, 41 Fed.Reg. 32,883 (1976), which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves.[1] The primary issue before us is whether

> On and after July [30], 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in inter-



this Order exceeds the Commission's jurisdiction to regulate the transportation and sale of natural gas in interstate commerce.

The FERC claims that the "prudent operator" obligation is an implied condi-

> state commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

Order No. 539–B is the third in a series of FERC orders, dealing with the development and maintenance of natural gas reserves. The first, Order No. 539, —— F.P.C. ——, 40 Fed. Reg. 49,571 (1975), was issued on October 14, 1975, without any notice, comment, or hearing as required for rule-making by the Administrative Procedure Act, 5 U.S.C. § 553 (1970). This Order stated the FERC's intention to enforce "delivery and supply obligations" purportedly contained in producer contracts and producer and pipeline certificates. The FERC's General Policy and Interpretations was amended by this Order by adding a new section, 18 C.F.R. § 2.83 (1975), delineating the FERC's policy on the enforcement of deliverability of natural gas services. On November 28, 1975, the Commission granted reconsideration of Order No. 539 on the application of a number of producers who asserted, among other grounds, that Order No. 539 misinterpreted both the producer-pipeline contractual arrangements and the existing certificate obligations. Issue was also taken with the institution of § 2.83 without following rule-making procedures. Administrative Procedure Act, 5 U.S.C. § 553 (1970). On March 26, 1976, the FERC issued a second order, Order No. 539–A, —— F.P.C. ——, 41 Fed.Reg. 14,531 (1976), to clarify its previous Order and properly to give notice of the intention of the Commission to promulgate § 2.83 pursuant to a rule-making procedure. Finally, the FERC issued Order No. 539–B, withdrawing § 2.83 and instituting § 157.41, on July 30, 1976.

tion of the certificates of public convenience and necessity that are required under the Natural Gas Act before companies may transport or sell natural gas in interstate commerce. The Commission relies upon the concept expressed as

> The impetus behind the FERC's actions was the charge made before various subcommittees of Congress that natural gas producers were avoiding the delivery obligations in their contracts of sale in order to realize greater profits. It was claimed that the producers were diverting natural gas from interstate to intrastate sales or withholding it in hope of future deregulation of the industry. No support for this charge appears in the record before us and the FERC stated in oral argument that its investigation has uncovered no evidence that the natural gas producers have been withholding supplies. We have held that when an FERC order originated in a policy decision of the agency and not as the outgrowth of factual determinations, the standard of review is whether the agency's action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1967). Under that standard we determine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Superior Oil Co. v. FERC*, 563 F.2d 191, at 201 (5th Cir. 1977).

Section 7(e) of the Natural Gas Act requires the FERC to make findings that a proposed retroactive condition, such as the one imposed by Order No. 539–B, is reasonable and is required by the public convenience and necessity. *Pure Oil Co. v. FPC*, 292 F.2d 350, 352–53 (7th Cir. 1961); *see Atlantic Refining Co. v. Public Service Comm'n*, 360 U.S. 378, 394, 79 S.Ct. 1246, 1256, 3 L.Ed.2d 1312 (1959) (Harlan, J., concurring) and *Texaco, Inc. v. FPC*, 290 F.2d 149, 157 (5th Cir. 1961). In light of the FERC's admission that the natural gas producers were not withholding natural gas from interstate commerce, it is questionable whether Order No. 539–B can survive the limited review explicated in *Superior Oil Co.* We need not reach this question, however, since it will be shown *infra* that Order No. 539–B is beyond the FERC's jurisdiction.



"service" in the Natural Gas Act[2] to establish its authority to hold certificate recipients to the "prudent operator" standard. No separate statutory or regulatory grant of jurisdiction has been cited by the FERC.

[1] The producers, however, argue that the FERC is prohibited from issuing Order No. 539–B by the specific exclusion of "the production and gathering of natural gas" from the Commission's jurisdiction and that the FERC cannot use the power to issue certificates to extend its jurisdiction into the excluded area.[3] We agree with the producers and vacate the FERC's Order.

[2] The jurisdiction of the FERC to regulate the natural gas industry is delineated by § 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) (1970):

> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural

2. Natural gas companies perform a service to the public, and the Commission's authority extends to ensuring that the service is properly performed even if it is not specifically manifested in a contractual relationship. *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960). This service is derived from the section of the Natural Gas Act empowering the FERC to issue certificates:

> . . . [a] certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions

gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

The producers are subject to the jurisdiction of the FERC when they engage in activities that can be classified as sales or transportation rather than as production or gathering. *Phillips Petroleum Co. v. State of Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954). Through the years, the "production or gathering of natural gas" exemption has been judicially narrowed. The progression can be seen by comparing *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949) with *United Gas Improvement Co. v. Continental Oil Co. (Rayne Field)*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965). The *Panhandle* case held that gas leases relate to the production or gathering of natural gas and are thus outside the jurisdiction of the FERC. The Supreme Court narrowly construed *Panhandle* in *Rayne Field* when it held that leases that are in essence sales of the gas reserves are within the FERC's jurisdiction. In *Rayne Field* the producers recast a conventional wellhead pur-

of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. 15 U.S.C. § 717f(e) (1970).

3. Natural Gas Act § 1(b), 15 U.S.C. § 717(b) (1977). This was the position taken by Commissioner Watts in his dissent from Order No. 539–B.



chase of natural gas as a purchase of the leasehold interests in the natural gas field. The Supreme Court described this sale of leasehold interests as "very close in economic effect to [traditional] sales of natural gas," *id.*, 85 S.Ct. at 1520, and stated that:

> *The "production or gathering" exemption relates to the physical activities, processes and facilities of production or gathering,* but not to sales of the kind affirmatively subjected to Commission jurisdiction. This accommodation of the two relevant clauses of § 1(b) gives content to the national objectives of the Natural Gas Act as expanded in Phillips, and to the Commission's jurisdiction to accomplish them, while in no way interfering with state regulatory power over the physical processes of production or gathering in furtherance of conservation or other legitimate state concerns. *Id.* 381 U.S. at 403, 85 S.Ct. at 1523. (Emphasis added.)

[3] The FERC can enforce "service obligations" contained in the certificates that it issues to producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production. This doctrine was developed in *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960) and *Sun Oil Co. v. FPC*, 364 U.S. 170, 80 S.Ct. 1388, 4 L.Ed.2d 1639 (1960), based on the power to issue certificates, see note 2 *supra*, and prevents producers from beginning delivery to another party after the initial contracts expire. Another line of cases permits the FERC to regulate the "abandonment of service." *Mitchell Energy Corp. v. FPC*, 533 F.2d 258 (5th Cir. 1976); *Panhandle Eastern Pipe Line Co. v. Michigan Consolidated Gas Co.*, 177 F.2d 942 (6th Cir. 1949).

No case has been found, however, that extends FERC jurisdiction directly into the physical activities, processes, and facilities of production and development. The cases recognizing the broad scope of the FERC's authority have nonetheless also recognized the "production or gathering" exclusion. In *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 65 S.Ct. 829, 89 L.Ed. 1206 (1945), after holding that the FERC could include production properties in the rate base of an interstate pipeline company, the Supreme Court stated:

> that does not mean that the part of § 1(b) which provides that the Act shall not apply "to the production or gathering of natural gas" is given no meaning. Certainly that provision precludes the Commission from any control over the activity of producing or gathering natural gas. For example, it makes plain that the Commission has no control over the drilling and spacing of wells and the like. *Id.* at 602–03, 65 S.Ct. at 839.

In *Continental Casualty Co. v. Associated Pipe & Supply Co.*, 447 F.2d 1041, 1052 (5th Cir. 1971), we echoed Mr. Justice Black's definition of "the production or gathering of natural gas:"

> "Production" of gas [means] the act of bringing gas from the earth, and "gathering" [means] the act of collecting gas after it has been brought forth. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 518, 69 S.Ct. at 1262 (Black, J., dissenting).

*See also Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. 84, 90, 83 S.Ct. 646, 650, 9 L.Ed.2d 601 (1963) (" 'production' and 'gathering' are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.")



Order No. 539–B clearly is intended to open the door to FERC involvement into forbidden production activities: [4]

> This [prudent operator] standard encompasses the obligations to develop the properties consistent with the performance requirements of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal, state or local government having jurisdiction; and the *standard of what a reasonably prudent producer would do with respect to the*

4. During oral argument, the FERC's counsel first stated that the FPC could require producers to drill new wells pursuant to Order No. 539–B; counsel later withdrew from this position and stated that the Commission could not do so because such a requirement would be beyond its power. The Commission staff, however, has not adopted a restrictive view of the authority granted to the FERC under Order 539–B. In its initial brief to the FERC in Docket No. RI75–112 (Dec. 6, 1976), the Staff stated:

> Immediate development of these known proved reserves will serve the public interest by increasing the supply of natural gas available to the interstate market. In the event that such development is not undertaken voluntarily by the producers, *staff recommends that the Commission use its authority pursuant to Order 539–B to insure full and timely development of these dedicated proved reserves.*
>
> An answer to the question of whether *production from "behind the pipe" reserves should be accelerated by drilling new wells* involves a policy determination based on a careful consideration of a number of factors . . . *Id.* at 213. (Emphasis added.)

5. The Supreme Court has discussed extensively the legislative history of the Natural Gas Act in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954) and *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949). *See also Panhandle Eastern Pipe Line Co. v. Public Service Comm'n of Indiana*, 332 U.S. 507, 514–21, 68 S.Ct. 190, 193–97, 92 L.Ed. 128 (1947); *Interstate Natural Gas Co. v. FPC*, 331 U.S. 682, 689–90, 67 S.Ct. 1482,

*drilling completion, workover, recompletion or abandonment of wells.* —— F.P.C. at ——, 41 Fed.Reg. at 32,884. (Emphasis added.) (Footnote omitted.)

To hold that the power to issue Order No. 539–B is within the jurisdiction of the FERC would all but eliminate the "production or gathering" exclusion and would allow the FERC to encroach on areas reserved to the states.[5] We cannot so extend the authority of the Commission.[6]

VACATED AND REMANDED.

1486–87, 91 L.Ed. 1742 (1947); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 601–03, 65 S.Ct. 829, 838–39, 89 L.Ed. 1206 (1945); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 609–13, 64 S.Ct. 281, 291–92, 88 L.Ed. 333 (1944); *Illinois Natural Gas Co. v. Central Illinois Public Service Co.*, 314 U.S. 498, 506–08, 62 S.Ct. 384, 397–98, 86 L.Ed. 371 (1942). It is clear that the Natural Gas Act was passed to fill the gap in regulation of the natural gas industry created by judicial holdings precluding state regulation of interstate commerce:

> The Natural Gas Act was designed to supplement state power and to produce a harmonious and comprehensive regulation of the industry. Neither state nor federal regulatory body was to encroach upon the jurisdiction of the other. Congress enacted this Act after full consideration of the problems of production and distribution. It considered the state interests as well as national interests. *Panhandle Eastern Pipe Line Co.*, 337 U.S. at 513, 69 S.Ct. at 1260.
> (Footnotes omitted.)

6. One final question raised concerns the "prudent operator" standard promulgated by Order No. 539–B. The argument is advanced that the "prudent operator" standard is inappropriate to FERC's goal to increase production of natural gas because "prudent operator" is a term of art employed in state regulations which are concerned with increasing the total recovery of hydrocarbons through the *conservation* of natural gas fields rather than permitting operators to waste energy resources by *exploitation* of reserves. We do not reach the issue due to our disposition on jurisdictional grounds.



APPENDIX B [689]

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

| | | |
|---|---|---|
| Policy With Respect To Enforcement Of Deliverability And Rendition Of Natural Gas Service Under Certificated Arrangements | ) | Docket No. RM76-8 |

ORDER NO. 539-B

ORDER CLARIFYING PRIOR ORDERS AND AMENDING SECTION 157 OF THE COMMISSION'S REGULATIONS UNDER THE NATURAL GAS ACT

(Issued July 30, 1976)

In Order No. 539[1] the Commission reiterated its policy to enforce certificated delivery obligations. In Order No. 539-A[2] the Commission clarified its prior order, granted in part and denied in part reconsideration, and issued a notice of proposed rulemaking to promulgate Section 2.83

1. Promulgating Statement of Policy, Order No. 539, Docket No. RM76-8, ____FPC____ (October 14, 1975).

2. Order Granting In Part And Denying In Part Reconsideration, Clarifying Order No. 539, Denying Stay, Noticing Of Proposed Rulemaking, Noticing Of Oral Argument And Granting Intervention, Order No. 539-A, ____FPC____ (March 26, 1976).

*Bracketed numbers indicate page in agency record.

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as a section of the Commission's General Policy and Interpretations. Written comments on the proposed rulemaking were received and oral argument before the Commission was held on May 4, 1976. The entire record in Docket No. RM76-8 is now before us for final determination.

In Order No. 539, we spoke of a "certificated minimum daily delivery obligation". From the reactions of the parties, we learned that the quoted phrase meant different

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things to different persons, depending, of course, on their respective views of the certainty of natural gas production. Some respondents interpreted the phrase to mean that a producer would be required to deliver a set volume of gas every day for the entire contract term or be subject to the criminal penalties of the Natural Gas Act,[3] while other persons related the meaning of the phrase to the producer's best efforts to deliver presently producible supplies. Our attempt in Order No. 539-A to clarify the meaning of "certificated minimum daily delivery obligation" did not settle the matter, as the continued confusion in the rulemaking proceeding showed. We must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers. In this order, based on all material submitted in Docket No. RM76-8, we will make clear the intention of the Commission with respect to its policy on certificate obligations and enforcement of such obligations.

Under Section 7 of the Natural Gas Act,[4] the Com-

3. Natural Gas Act, §21; 15 U.S.C. §717t.

4. Natural Gas Act, §7; 15 U.S.C. §§717f(a)-(e).



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mission authorizes a natural gas company to perform a service, the sale for resale in interstate commerce of natural gas. In order for this sale by a producer to be lawful, it must procure from the Commission a certificate of public convenience and necessity. This certificate is the physical evidence of the producer's right to commence the approved service.[5] The certificate itself sets forth the terms and conditions under which the producer must operate, which include but are not limited to those obligations incurred by reason of the contract of sale.

Whatever the obligations voluntarily entered into by the producer in the contract of sale with the pipeline, the contract terms must normally bow to the conditions included in the certificate. Where, however, the contract provisions incorporated into the certificate include greater responsibilities

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and obligations than those imposed by the certificates, such as in a warranty of delivery agreement, the producer, of course, will be held accountable to those greater responsibilities and obligations.

Some parties to this proceeding advance the argument that a common term in producer-pipeline contracts called the "sole discretion" clause permits the producer complete control over deliverability to the pipeline. Thus, a typical reservations clause in a sales contract provides, in part, that the seller reserves the right "to operate its property free from any control by Buyer in such manner as Seller, in its *sole discretion* may deem advisable, in-

5. *Atlantic Refining Co. v. Public Service Commission of N.Y.*, 360 U.S. 378, 389 (1959).

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cluding without limitation, the right to drill new wells, to repair and rework wells and to abandon any well . . ."[6] (Emphasis added.) Even though the view that the seller rules the transaction is not universally held even in the industry,[7] the Commission wants to make clear that its certificate conditions, and the incidents of service which is represents, are superior to any limitations on Commission authority contained in the contract.

The question then, which the Commission attempted to address in Order Nos. 539 and 539-A, is what standard or test of deliverability the producer is required to live up to under the provisions of the Natural Gas Act and the rules and regulations of this Commission. Natural gas companies[8], as that term is defined in the Natural Gas Act[9], are required under Sections 4, 5, and 7[10] to fulfill certain service



obligations arising from the Act itself[11], together with other responsibilities that may result from other Federal

6. See, *e.g.*, Comments of Tenneco Oil Company, Docket No. RM76-8, Appendix A, p. 7, filed April 19, 1976.

7. Oral Argument, Tr. 95-96.

8. The Supreme Court's decision in *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1974) found independent producers to be "natural gas companies" within the meaning of Section 2(6) of the Natural Gas Act, 15 U.S.C. 717a(6).

9. 15 U.S.C. §717a.

10. 15 U.S.C. §§717c, 717d, 717f.

11. *F.P.C. v. Louisiana Power and Light Company*, 406 U.S. 621 (1972); *Pennsylvania Water and Power Company v. F.P.C.*, 343 U.S. 414, 422 (1952).



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or State laws or the law of private contracts. Pursuant to the Act itself, however, jurisdictional sales, service, and operation of natural gas companies must be just, reasonable, not unduly discriminatory, preferential, or otherwise unlawful, and in the public interest.

In response to the allegations that have been made concerning our authority to enforce certificate obligations and to condition certificates to aid in this enforcement, Section 7(e) of the Natural Gas Act[12] provides that, in order for the Commission to issue a certificate of public convenience and necessity, it must determine that the applicant is ". . . able and willing *properly* to . . . perform the service proposed . . ." (emphasis added). Certain parties to this proceeding have asserted that this finding is made only at the commencement of the sale. Such a contention does not comport with the ordinary meaning of "service", which implies a continuing obligation, nor with the remainder of the section, which requires that the applicant be found to be willing to conform to the provisions of the Natural Gas Act and the Commission's Regulations.[13] The Commission has long recognized a distinction between the service to the public that is certificated and the contractual agreement that provides for the sale, especially since the service obligation outlives the contractual authorization.[14] Since the requirement of service continues until the Commission permits abandonment, and since the holder of a certificate from the Commission must comply with the

12. 15 U.S.C. §717f(c).

13. *Mitchell Energy Co. v. F.P.C.*, ____F.2d____, No. 75-3110 (5th Cir., June 11, 1976).

14. *Sunray Mid-Continent Oil Co. v. F.P.C.*, 364 U.S. 137 (1960) at 152-153.

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rules and regulations thereof, it is simply incorrect to assert that the Commission cannot act to preserve the integrity of its certification process by conducting an oversight review of an on-going

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service obligation.[15] A mere reference to the authority granted the Commission in Section 5(a) of the Act[16] should suffice to prove the correctness of the view that the Commission has a continuing responsibility to the public to insure that recipients of certificates issued by the Commission are, throughout the life of the certificate, performing consistent with their obligations under the Natural Gas Act.

Historically, jurisdictional actions of natural gas companies have been reviewed by this Commission on the basis, among others, of whether the company acted prudently under the circumstances presented.[17] The prudent operator standard has long been established as an implied covenant in lease agreements, which means that producers are very familiar with the requirements of this standard.[18] Furthermore, state regulatory agencies, whose

15. *United Gas Pipe Line Co. v. F.P.C.*, 385 U.S. 83, 89 (1966).

16. 5 U.S.C. §717d.

17. *F.P.C. v. Natural Gas Pipeline Company*, 315 U.S. 575 (1942).

18. *See*, Williams, Howard R. and Meyers, Charles J., *Oil and Gas Law*, §806, Prudent-Operator Standard, Volume 5, Matthew Bender & Company, Inc. (1972). *See also*, Oral Argument of May 4, 1976, in Docket No. RM76-8, Tr. 6-7, 62-64, 95-96, 122; *Gas and Oil*, §127 Generally; prudent operator rule, 38 Am. Jur. 2d 601 (1968).



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principal purpose is conservation of natural resources, require producers to conform to their codified regulations, which are consistent with the responsibilities imposed by the prudent operator standard.[19] The Department of the Interior has, in effect, incorporated the prudent operator test into its offshore regulations by the use of the terms "reasonable" and "diligence" in describing the lessee's obligations as set forth in the leasing agreement.[20] Obviously, then, all producers are acquainted with the strictures of the prudent operator standard. Therefore, there should be no contention

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that the Commission's action in the instant order is insufficiently specific for respondents to understand the responsibilities incurred in complying with the prudent operator standard.[21]

Once deliveries have commenced under the certificate, as conditioned, the responsibility for the development and maintenance of the gas reserves underlying the committed acreage rests with the producer, and the applicable standard by which to judge whether a producer is properly proceeding with these responsibilities will be the above-referenced "prudent operator standard".

This standard encompasses the obligations to develop the properties consistent with the performance require-

19. Oral Argument, Tr. 15.

20. 30 C.F.R. §250.33, 43 C.F.R. §§ 3307.3-2, 3307.3-4.

21. Our clarification herein should not be interpreted as relieving pipelines from their obligations, arising under the Natural Gas Act, to enforce certificated contractual obligations unilaterally where the need arises.

ments of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal,[22] state or local government having jurisdiction; and the standard of what a reasonably prudent producer would do with respect to the drilling completion, workover, recompletion or abandonment of wells.

We have set forth in this order the nature and extent of the service obligations incurred by a natural gas company in accepting a certificate from this Commission, along with tracing the historical link between service and prudent operation. Therefore, it is consistent with the expression in Order Nos. 539 and 539-A of a statement of policy, that the Commission reiterates its intention to enforce the prudent operator standard as implicit in the service obligations contained in all existing certificates.



The Commission's authority to hold certificate recipients to the prudent operator standard rests, as we have previously stated, in the concept expressed in the Natural Gas Act as service, as that term has been interpreted by the Commission and the Courts. For example, the Supreme Court in *Sunray Mid-Continent Oil Company v. Federal Power Commission*[23] stated:

22. Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331, *et seq.* *See also,* 30 C.F.R. §§ 250, et seq.; 43 C.F.R. §§ 3300, *et seq.; OCS Orders 1 through 12, Governing Oil, Gas, And Sulphur Leases To The Outer Continental Shelf Gulf Of Mexico Area,* United States Department of the Interior, Geological Survey, Conservation Division, January, 1975.

23. 364 U.S. 137 (1960).





> [t]he Commission's practice supports its authority here in the terms of §7(e). It has long drawn a distinction between the underlying service to the public a natural gas company performs and the specific manifestation—the contractual relationship —which that service takes at a given moment.[24]

The Commission has embodied this idea into its certificates of public convenience and necessity by including as a condition thereof the following language:

> The grant of the certificates issued in paragraph (A) above shall not be construed as a waiver of the requirements of Section 7 of the Natural Gas Act or of Part 154 or Part 157 of the Commission's Regulations thereunder and is without prejudice to any findings or orders which have been or which may hereafter be made by the Commission in any proceedings now pending or here instituted by or against Applicants. Further, our action in this proceeding shall not foreclose or prejudice any future proceedings or objections relating to the operation of any price or related provisions in the gas purchase contracts herein involved. The grant of the certificates aforesaid for service to the particular customers involved does not imply approval of all of the terms of the contracts, particularly as to the cessation of the service upon termination of said contracts as provided by Section 7(b) of the Natural Gas Act. The grant of the certificates aforesaid shall not be

24. *Id.* at 152.

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> construed to preclude the imposition of any sanctions pursuant to the provisions of the Natural Gas Act for the unauthorized commencement of any sales of natural gas subject to said certificates.[25]

The Commission has only recently spoken to the issue presented in this rulemaking procedure, the relationship of the contract to the certificate and which prevails if there is a conflict. In its Opinion No. 662 the Commission held that:

> [t]he contract between Texas Eastern and Gulf obviously gave rise to rights and obligations; much is made in the briefs before us concerning the nature, extent and enforceability of those rights and obligations. We set these matters aside. We look instead to Gulf's certificate of public convenience and necessity, for it too gave rights and obligations, and these are clearly ours to interpret, modify, or enforce as the case may require. (Footnote omitted.)[26]

As an additional objection to a Commission imposed standard of deliverability, the producers have strenuously argued that Section 1(b) of the Natural Gas Act prohibits the Commission from conditioning, pursuant to Section 7(e) of the Act, a certificate to aid in the enforcement of delivery obligations that exist in a contract as certificated. Section 1(b) does not, however, preclude

25. *See, e.g.*, Amoco Production Company, *et al.*, Docket No. CI63-479, *et al.*, issued September 19, 1975.

26. *Gulf Oil Corporation*, Docket No. CI64-26, 51 FPC 1340, 1352 (1974).



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the Commission from enforcing the contractual provisions of a gas sales contract and various delivery obligations contained therein or in the certificate. As the Court indicated in *Phillips Petroleum Company v. Wisconsin*,[27] "sales in interstate commerce for resale by producers to interstate pipeline companies do not come within the 'production or gathering' exemption." Once a contract has been certificated, the obligations must be performed in accordance with the provisions of the Natural Gas Act, including Section 7(b) of the

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Act. If the seller under a certificate is not meeting the delivery obligations of such certificate, there has been either a partial or total abandonment of certificated service which requires Commission approval pursuant to Section 7(b). Accordingly, attachment of a condition to a certificate to assure compliance with Section 7(b) of the Act cannot be considered an unreasonable condition contrary to the requirements of Section 7(e) of the Act. Moreover, Section 1(b) of the Act does not, in any fashion, limit the Commission's authority conferred upon it by Section 7(b).

Despite the Commission's belief that the prudent operator standard is implicit in the service obligation included in all certificates issued by this Commission, we wish to make this point clear to all future certificate applicants by including as a condition in all certificates issued on or after the date of this order notice of the supremacy of the certificate to the contract and the application of the

27. 347 U.S. 672, 680-81 (1954).

[697]

prudent operator standard to deliverability obligations. Therefore, pursuant to the notice of proposed rulemaking set forth in Order No. 539-A, the Commission will amend its Rules and Regulations to add a new Section 157.41, to read as follows:

> On and after July __, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

A party that objects to the inclusion of this condition in its certificate may reject the certificate outright or accept with the reservation of its right to appeal the offending condition under Section 19(b).[28]

[698]

In light of our clarification of Order Nos. 539 and 539-A holding a producer to the legally applicable principle of the prudent operator standard, Section 2.83 of the Commission's Regulations is hereby deleted from the Commission's General Policy and Interpretations. As to

28. 15 U.S.C. §717r.



[699]

all certificates issued from October 14, 1975 to date that contain Section 2.83(d) as a condition thereof, whether accepted and/or whether rehearing or reconsideration of the order issuing said certificate was sought or not, the Section 2.83(d) condition contained therein is hereby vacated, but each and every other condition included in said certificate is fully applicable, unless such condition has become the subject of a petition for rehearing or reconsideration that has been granted by this Commission.

[699]

In lieu of the Section 2.83(d) condition included in all certificates issued on or after the October 14, 1975 date of Order No. 539, the Commission will substitute therefore the prudent operator standard presented herein and incorporated into the Commission's Regulations as new Section 157.41. This provision applies whether rehearing or reconsideration was sought for the Section 2.83(d) condition. If, however, rehearing or reconsideration was sought, whether granted as yet or not, those proceedings are incorporated into this rulemaking proceeding for resolution. Because of the Commission's decision expressed in this order to use the prudent operator test to judge the service obligation of the producer under the certificate, all petitions for rehearing or reconsideration pending before this Commission are granted in part and denied in part.

Finally, the data necessary to facilitate any Commission action deemed necessary in implementing the instant order is either currently required to be filed by the appropriate persons or will be required as a result of our order implementing Form No. 108. More specifically,

[699]

any information and materials submitted by virtue of Form No. 108, Form No. 15 and Form No. 40 will be used to assist the Commission and its Staff in enforcing certificated obligations.

*The Commission finds:*

(1) The Commission's prior orders, Order Nos. 539 and 539-A, should be clarified consistent with this order.

(2) The notice and opportunity to participate in this proceeding with respect to the matter presently before the Commission through the submission, in writing of comments and through participation at oral argument before the Commission, is consistent and in accordance with all procedural requirements therefore as prescribed in Section 553, Title 5 of the United States Code.

(3) The amendment to Section 157 of the Commission's Regulations Under the Natural Gas Act is necessary and appropriate for the administration of the Natural Gas Act.

(4) Section 2.83 should be deleted from Part 2, Statements of General Policy and Interpretations of the Commission.

[700]

(5) The Commission should include in all certificates issued on or after the date of issuance of this order a condition stating that all sales made pursuant to the certificate are subject to review under the prudent operator standard.

(6) It is the public interest to delete Section 2.83(d)



[701]

as a condition to all certificates issued on or after October 14, 1975, whether such certificates were accepted or not, and insert in its place the condition set forth in the newly promulgated Section 157.41 of the Commission's Regulations under the Natural Gas Act.

(7) It is in the public interest that all petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) as a condition to a certificate are incorporated into this proceeding for disposition of that issue and should be granted in part and denied in part for the reasons expressed in this order.

[701]

*The Commission orders:*

(A) The Commission's Order Nos. 539 and 539-A are clarified consistent with this order.

(B) The Commission, acting pursuant to its authority under the Natural Gas Act, as amended, particularly Sections 4, 5, 7, and 16 thereof, 15 U.S.C. 717c, 717d, 717f, and 717o, hereby orders that its General Rules, Title 18 of the Code of Federal Regulations, be amended by adding a new Section 157.41 as follows:

> On and after July __, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the

[701]

certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

(C) Section 2.83 is deleted from Part 2, Statements of General Policy and Interpretations of the Commission.

(D) The Section 2.83(d) condition attached to all certificates issued on or after October 14, 1975, is deleted from such certificates and the condition contained in Section 157.41 of the Commission's Regulations under the Natural Gas Act is inserted in its place.

[702]

(E) All petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) or as a condition to a certificate of public convenience and necessity are incorporated into this proceeding for disposition of that issue and are granted in part and denied in part for the reasons expressed in this order.

By the Commission.

Commissioner Watt, dissenting, filed a separate statement appended hereto.

(SEAL)

Kenneth F. Plumb,
Secretary.



[703]

[703]

| | | |
|---|---|---|
| Policy With Respect To Enforcement Of Deliverability And Rendition Of Natural Gas Service Under Certificated Arrangements | ) | Docket No. RM76-8 |

(Issued July 30, 1976)

WATT, Commissioner, *dissenting*:

I have worked hard with my fellow Commissioners in an effort to resolve our differences in this case. Unfortunately, there is one major issue we have not been able to agree upon. Therefore I must dissent.

Order No. 539 from its inception has been a nightmare for the Federal Power Commission. That Order states, "The Commission has concluded that it should formally reiterate its policy with respect to the enforcement of the requirements of the Natural Gas Act . . ." because ". . . Questions concerning deliverability and supply obligations of natural gas producers and natural gas pipelines have arisen in connection with numerous Congressional hearings involving the Natural Gas Act." The Order proceeds then to outline what at the time was thought by a few to be the Federal Power Commission policy.

The Order has brought confusion and misunderstandings because many have interpreted it to be an unauthorized extension of jurisdiction not conferred by the Natural Gas Act. As a result of that October 1975 Order, access to over 18 Bcf of natural gas is being denied to the inter-

[703]

state market. In addition, there could well be a substantial quantity of natural gas that has not been considered for introduction into the interstate market because of fears created by the illegal extensions of authorities assumed by the Federal Power Commission.

Once the Commission paused to look at what had been done in the original Order, Order No. 539-A was issued in an attempt to clarify and straighten out the errors. In my opinion, the rewriting of the policy statement in Order No. 539-A was correctly and properly done. But unfortunately, the majority insisted upon maintaining the §2.83 (d) condition in all certificates. The majority now has recognized that error and in Order 539-B has withdrawn and expunged from all those certificates the ill-conceived language. (I have consistently dissented to the inclusion of the §2.83(d) language in all certificates.)

[704]

Now the majority in an attempt to again clarify and straighten out the problems that continue to multiply, has issued a New Order that in my judgment is, also, in error. It creates a substitute condition (Section 157.41) for all certificates that dictates action which is beyond FPC authority.

In my opinion, the Federal Power Commission authority, conferred by the Natural Gas Act with respect to producers, is limited virtually to rate regulation.[1] The Federal Power Commission does not have the authority

1. See e.g. *Interstate Natural Gas Co. v. F.P.C.;* 331 U.S. 682, 690, 691 (1946) and *Colorado Interstate Gas Co. v. F.P.C.;* 324 U.S. 581, 597-604 (1946).



[704]

to require the development of gas reserves dedicated to the interstate market. That authority rests in the lessor or appropriate governmental agency specifically granted such authority by enabling legislation.

A possible result of today's Order is that additional gas will be lost to the interstate market while producers seek judicial remedy of the errors of the Federal Power Commission. It is unfortunate that the Commission continues to insist upon asserting jurisdiction over activities over which it has no authority.

JAMES G. WATT
Commissioner

## APPENDIX C

The Natural Gas Act, 15 U.S.C. § 717 et seq., provides, in pertinent part:

§ 1(b) The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.
15 U.S.C. § 717(b).

§ 7(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.
15 U.S.C. § 717f(b).

§ 7(c) No natural-gas company or person which will be a natural-gas



company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations. ...
15 U.S.C. § 717f(c).

§ 7(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public

convenience and necessity may require.
15 U.S.C. § 717f(e).

Supreme Court, U. S.
FILED
JUL 26 1978
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No. 77-1654

# In the Supreme Court of the United States

OCTOBER TERM, 1978

---

CONSUMER FEDERATION OF AMERICA, ENERGY POLICY TASK FORCE, PETITIONER

*v.*

FEDERAL ENERGY REGULATORY COMMISSION

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

---

## MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION

---

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**MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION**

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Petitioner, Consumer Federal of America, Energy Policy Task Force ("EPTF"), seeks review of the same judgment of the court of appeals that the Federal Energy Regulatory Commission is asking the Court to review in No. 77-1652, *Federal Energy Regulatory Commission* v. *shell Oil Company, et al.*[1]

The Commission adopted a regulation, 18 C.F.R. 157.41, providing that as of July 30, 1976, all certificates of public convenience and necessity issued to natural gas producers for the sale of natural gas for resale in interstate commerce were conditioned "to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated [under the certificate]." EPTF petitioned

---

[1]We are furnishing petitioner with a copy of the Commission's petition in No. 77-1652.

for review of the regulation on the ground that the "prudent operator" standard was inadequate to assure fulfillment of certificated delivery obligations. Various producers petitioned for review on the ground that the regulation exceeded the Commission's jurisdiction. While maintaining its own challenge to the regulation, EPTF intervened in support of the Commission against the challenge by the producers.

The court of appeals agreed with the producers. It set aside the regulation on the ground that it applied to production and gathering activities that were excluded from the Commission's jurisdiction by Section 1(b) of the Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717(b) (Pet. App. 1a).

The question presented by the Commission in its petition for certiorari in No. 77-1652 is whether the "production and gathering" exclusion in Section 1(b) of the Natural Gas Act denies the Commission authority to require certificated producers to "observe the standard of a prudent operator" in developing and maintaining delivery of gas from their dedicated reserves so as to fulfill their duty to continue service under Section 7 of the Act.[2] The first question presented by EPTF (Pet. 2) is largely the same; the only material difference is that, instead of

---

[2]The precise question as stated in the Commission's petition is as follows (Pet. No. 77-1652, p. 2):

> Whether the production and gathering exclusion in Section 1(b) of the Natural Gas Act denies the Federal Energy Regulatory Commission authority to require certificated producers of natural gas to "observe the standard of a prudent operator" in developing and maintaining delivery of gas from their dedicated reserves, so as to assure the fulfillment of their duty, under their certificates and Section 7 of the Act, to continue interstate service until the Commission authorizes them to abandon that service.



the "prudent operator" standard, EPTF speaks of the Commission's authority to enforce "in accordance with an appropriate standard" the delivery obligations of producers under their certificates of public convenience and necessity issued pursuant to Section 7 of the Act.[3]

In addition, EPTF presents a second question based on its contention in the court of appeals that the "prudent operator" standard adopted by the Commission does not constitute a proper measure for enforcing delivery obligations under certificates of public convenience and necessity (Pet. 2).

The court of appeals did not reach the second question because of its jurisdictional ruling against the Commission under the "production and gathering" clause.[4] Thus, EPTF's first question largely duplicates the question presented by the Commission, while EPTF's second question presents an issue that has not been decided by the court of appeals.

EPTF's petition should not be granted with respect to the second question it presents. Since that question has not been ruled on by the court of appeals, it is not

---

[3]"1. Whether the Federal Energy Regulatory Commission is precluded by the 'production and gathering' exemption contained in Section 1(b) of the Natural Gas Act from enforcing, in accordance with an appropriate standard, the delivery obligations under certificates of public convenience and necessity issued to producers of natural gas pursuant to Section 7 of the Act" (Pet. 2).

[4]The court stated: "One final question raised concerns the 'prudent operator' standard promulgated by Order No. 539-B. The argument is advanced that the 'prudent operator' standard is inappropriate to FERC's goal to increase production of natural gas because 'prudent operator' is a term of art employed in state regulations which are concerned with increasing the total recovery of hydrocarbons through the *conservation* of natural gas fields rather than permitting operators to waste energy resources by *exploitation* of reserves. We do not reach the issue due to our disposition on jurisdictional grounds" (Pet. App. 10a n. 6; emphasis in original).

ripe for consideration by this Court at this time. If the Court grants review of the court of appeals' decision and reverses that court's ruling that the Commission lacked jurisdiction to adopt its rule, EPTF's contention will then be appropriate for initial consideration by the court of appeals on remand.[5] If, on the other hand, the Court denies review of the decision below or affirms that decision after review, there will be no reason for the Court to consider EPTF's claim that the Commission should have gone further. The Commission does not oppose the granting of EPTF's petition limited to the first question it presents.[6]

Respectfully submitted.

WADE H. MCCREE, JR.,
*Solicitor General.*

ROBERT R. NORDHAUS,
*General Counsel,*
*Federal Energy Regulatory Commission.*

JULY 1978.

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[5]The Commission contended below, and would contend on remand, that its rule should be upheld because the choice of remedies to enforce delivery obligations is committed to the Commission's responsible discretion. Cf. *Federal Communications Commission* v. *National Citizens Committee for Broadcasting*, No. 76-1471, decided June 12, 1978.

[6]Should its petition be denied and the Commission's petition be granted, EPTF could, of course, file a brief on the merits as a respondent in support of the petitioner in the latter case.

DOJ-1978-07

Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1978

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**No. 77-1652**

---

FEDERAL ENERGY REGULATORY COMMISSION,
*Petitioner,*

v.

SHELL OIL CO., ET AL.,
*Respondents.*

---

**No. 77-1654**

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CONSUMER ENERGY COUNCIL OF AMERICA,
*Petitioner,*

v.

FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

---

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT**

---

## BRIEF OF PETITIONER CONSUMER ENERGY COUNCIL OF AMERICA

---

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1978

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**No. 77-1652**

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FEDERAL ENERGY REGULATORY COMMISSION,
*Petitioner,*

v.

SHELL OIL CO., ET AL.,
*Respondents.*

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**No. 77-1654**

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CONSUMER ENERGY COUNCIL OF AMERICA,
*Petitioner,*

v.

FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

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**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT**

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## BRIEF OF PETITIONER CONSUMER ENERGY COUNCIL OF AMERICA 1/

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## OPINIONS BELOW

The opinion of the court of appeals, Pet. App. A, pp. 1a-10a,

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1/ Consumer Energy Council of America is the successor organization (footnote continued)

is reported at 566 F.2d 536. Order 539-B of the Federal Power Commission, which is the order reviewed by the court of appeals, is reproduced at Pet. App. B, pp. 11a-29a. 2/

## JURISDICTION

The judgment of the court of appeals was entered on January 20, 1978. A petition for certiorari was filed on May 20, 1978. The Court granted the petition, along with a petition of the Federal Energy Regulatory Commission, on October 2, 1978, and consolidated the two cases. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## QUESTIONS PRESENTED

1. Whether the Federal Energy Regulatory Commission is precluded by the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act from enforcing in accordance with an appropriate standard, producer delivery obligations under certificates of public convenience and necessity issued pursuant to Section 7 of the Act.

(footnote continued)
to Petitioner Consumer Federation of America's Energy Policy Task Force.

2/ The court of appeals opinion and Order 539-B can also be found as an appendix to the Federal Energy
(footnote continued)



2. Whether the "prudent operator standard" constitutes a proper measure for enforcing producer delivery obligations under certificates of public convenience and necessity.

## STATUTES INVOLVED

Section 1(b), 4(d), 7(b), 7(c) and 7(e) of the Natural Gas Act, 15 U.S.C. § 717(b), § 717c(d), § 717f(b), § 717f(c), and § 717f(e), are, in relevant part, reproduced in Appendix A, infra, pp. A1-A3.

## STATEMENT

The two petitions for certiorari, one filed by Consumer Federation of America's Energy Policy Task Force, the Consumer Energy Council of America's predecessor organization ("petitioner"), and the other by the Federal Energy Regulatory Commission ("Commission" or "FERC"), pose critical questions about the Commission's jurisdiction and, more importantly, about the Commission's

(footnote continued)
Regulatory Commission's petition, although the pagination differs slightly.

responsibility to adopt effective measures in order to assure consumers an adequate and reliable supply of gas under delivery arrangements certificated pursuant to § 7(c) of the Natural Gas Act, 15 U.S.C. § 717f(c). These issues, revolving around Order 539-B promulgated by the Federal Power Commission 3/ in July of 1976, should not, and cannot, be considered as abstract questions under the Natural Gas Act. The validity of the approach set forth in Order 539-B must be considered in the context of events transpiring since the late 1960's, from the growing shortages in natural gas deliveries to the recently passed Natural Gas Policy Act. It is this context which, we submit, underscores Order 539-B's legal failings, both in its selection of a standard governing producer delivery obligations and in its establishment of an enforcement mechanism. Although the Court has in recent years demonstrated its awareness of, and sensitivity to the problem of declining gas supplies, see, e.g., FPC v. Transcontinental Gas Pipe Line Corp., 423 U.S. 326, 334

3/ On September 30, 1977, the FPC ceased to exist and its functions were transferred to the Federal Energy Regulatory Commission. Department of Energy Organization Act, Pub. L. 95-91, 91 Stat. 565, and Executive Order No. 12009, 42 Fed. Reg. 46267 (Sept. 15, 1977).



(1976); Mobil Oil Corp. v. FPC, 417 U.S. 283, 331 (1974); FPC v. Louisiana Power & Light Co., 406 U.S. 621, 626 n.2 (1972), an overview of the historical setting of the problem nevertheless seems appropriate.

1. Historic Supply and Consumer Reliance

The issuance of Order 539-B and the deliberations of the court of appeals below arose in a context virtually unprecedented in the history of natural gas regulation: a severe natural gas shortage. From the passage of the Natural Gas Act in 1938 until only a few years ago, the primary focus of Commission regulation had been on the price consumers would pay for gas transported in interstate commerce. The adequacy of supply was seldom at issue; in fact, the market for natural gas was a buyer's market, 4/ and, if anything, there was a clear surplus of useable gas, at low prices in both the interstate and intrastate markets.

As a result of this abundance, there developed an enormous investment in, and reliance upon, gas

4/ Federal Power Commission, National Gas Survey, Vol. I, p. 114 (1975).

supplies committed to the interstate market. Thus, by 1976, well after the supply picture had changed markedly, nearly 45 million customers had come to rely upon the services of the gas utility industry, 5/ and of the nation's total energy consumption, natural gas represented 27.3 per cent, exceeded only by oil which (including transportation) represented 47.2%. 6/ The extent of this reliance did not go unnoticed by the Federal Power Commission. In a 1975 report, the FPC pointed out that "the events of the past year have illustrated in dramatic and unmistakable terms the alarming degree to which this Nation's economic and social welfare are dependent upon assured and adequate energy supplies." 7/ The report went on to note that over "84 percent of the U.S. population lives in communities served with gas." 8/ Industrial reliance was also substantial -- due to major investments of capital, pollution-control considerations and, in some cases,

5/ American Gas Association, Gas Facts 1976 Data, 1, 69 (1977).

6/ Id. at 61.

7/ Federal Power Commission, National Gas Survey, Vol. I, p. 6 (1975).

8/ Homeowners' investment in gas
(footnote continued)



the lack of a suitable substitute fuel. 9/ In short, a nationwide network of interrelated obligations, investments and economic and social well-being had developed in reliance upon commitments of natural gas to the interstate market.

In the early 1970's, however, the supply picture changed dramatically, as deliveries to the interstate market began to dwindle. 10/ This altered situation required the FPC for the first time to focus its regulatory tools on assuring fulfillment of existing delivery obligations and on allocating the declining supply among competing uses. The need for action was enhanced by a widening gap between the price of gas in the unregulated intrastate

(footnote continued)
appliances alone exceeds $20 billion. Id. at 50.

9/ Id. Industrial use accounted for over 41.4 percent of total natural gas consumption in 1976, and was the largest single sector among consumers of natural gas for that year. American Gas Association, Gas Facts 1976 Data at 62, Table 50 (1977).

10/ Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce,
(footnote continued)

market and that in the regulated interstate market. This gap created an incentive for producers not to deliver all available gas to the interstate market, but to sell that gas instead in the intrastate market or conserve it in hope that deregulation, or FPC action on rates, would raise the price producers could charge for interstate sales. 11/

At the receiving end of the chain of distribution, the FPC responded to the shortage with its curtailment program. Flatly stating that the

(footnote continued)
Federal Regulation and Regulatory Reform, H.R. Doc. No. 95-134, 95th Cong., 1st Sess. 385-88 (1976). See also FPC Staff Report No. 2, National Gas Supply and Demand 1971-1990 (1972): "The emergence of a natural gas shortage during the past two years marks an historic turning point -- the end of natural gas industry growth uninhibited by supply considerations." Id. at xi.

11/ FPC data reflect the growing shortage and the incentive created by the disparity between interstate and intrastate rates. For example, during this period, curtailments of interstate service rose rapidly, while producers dedicated an ever larger proportion of newly found reserves to the intrastate
(footnote continued)



curtailment provisions in the pipeline-utility contracts were "incompatible with consumer protection" in times of shortage, the FPC directed curtailment in the manner it felt would best serve the public interest. FPC Order 467, 49 FPC 85, 86, 38 Fed. Reg. 1503, 1504 (Jan. 8, 1973). See also, FPC v. Louisiana Power & Light Co., 406 U.S. at 646.

By contrast, the FPC was slow to take any measures to assure that producers maintained their deliveries from fields which were already dedicated to interstate commerce under FPC certificates. 12/ It was

(footnote continued)
market. Thus, cumulative firm curtailments in the interstate market grew from 17,535,000 Mcf in 1970 to 3,181,903,600 Mcf in 1976. See FPC Bureau of Natural Gas Staff Report, Report on Monthly Curtailments Based on FPC Form No. 17, Schedule II, sheets 2-4 (June 1977). Similarly, the interstate market's share of new reserve additions fell from 68% in 1966 to 13% in 1975, while intrastate additions rose correspondingly from 32% to 87%. FPC Opinion No. 770-A Nov. 5, 1976, at 116.

12/ See, e.g., Hearings on the Availability of Natural Gas Supplies
(footnote continued)

not until October of 1975, that the FPC turned finally to defining and enforcing producer delivery obligations under the Act.

2. Order 539-B Proceedings and Court Review

The FPC issued Order 539 on October 14, 1975. 13/ In its

(footnote continued)
Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st & 2d Sess. at 28 (1976).

During this period, the FPC undertook only one meaningful enforcement action to counter flagging deliveries. See Gulf Oil Corp. v. FPC, 563 F.2d 588 (3d Cir. 1977), cert. denied, 98 S.Ct. 1235 (1978). The potential results of concerted enforcement efforts are well demonstrated by the fact that following firm FPC action, Gulf's deliveries from April 1977 through March 1978 were 6,250,000 Mcf in excess of its certificate obligation, as compared, for example, to a shortfall of over 16,000,000 Mcf from November 1976 through February 1977. See Gulf Oil Corporation, Supplemental Statement Reflecting Refund and Interest, Docket No. CI 64-26, filed May 3, 1978, with the Federal Energy Regulatory Commission.

13/ Order No. 539, 40 Fed. Reg. 49571
(footnote continued)



preamble to Order 539, the FPC acknowledged that the order was issued in answer to recurring questions raised during Congressional hearings concerning the deliverability obligations of natural gas producers. R. 147. 14/ The FPC then stated that it had been and continued to be the Commission's policy:

> to enforce all delivery and supply obligations of jurisdictional natural gas producers and jurisdictional natural gas pipelines, as they may be occasioned by applicable regulations of the Commission and the statutory standards of the Natural Gas Act, which govern -- and, therefore, which are incorporated within -- the certificates for all certificated arrangements authorized pursuant to the Act. R. 148.

(footnote continued)
(Oct. 23, 1975) R.147-58. Order 539 and the subsequent Order 539-A can also be found in the Joint Appendix, to be filed in this case. It is our understanding that the Joint Appendix will also reflect the page numbers from the record.

14/ See Congressional reports cited in Order 539, n. 1. R.147-48.

In so announcing its policy, the FPC also made clear that certificates imposed obligations on natural gas companies extending beyond the terms of the individual contract between the producer and pipeline. R.152. To aid in carrying out its policy, the FPC added a new section, § 2.83, to the General Policy and Interpretations in Title 18 of the Code of Federal Regulations. In subsection (a) of § 2.83, the FPC stated that natural gas producers must comply with all "deliverability or production of natural gas requirements to meet . . . certificated operations, services, developments, quantities, volumes, or sales." (Emphasis added.) R.155. Subsection (d) of § 2.83 then set forth specific terms to be included in all future certificates, imposing on the certificate holder the obligation to report the results of any reserve determination or redetermination, and explicitly providing that the producer had a "certificated delivery obligation" to be determined by reference to the contract provision, as modified by the certificate, and to remain in force unless a change were authorized by the FPC, based upon the certificate holder's documentation of the reasons for the change. R.157.

The issuance of Order 539 brought forth a storm of protest from the



producers, in the form of applications for rehearing and reconsideration. The producers claimed that Order 539's enforcement policy would run afoul of the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b), and that it represented a fundamental misunderstanding of the nature of producers' obligations. See R.170, 310, 326, 355. In response to those protests, the FPC issued Order 539-A on March 26, 1976. 15/ While purportedly defending the position set forth in Order 539, Order 539-A in fact reflected a significant retreat from the FPC's previous position on delivery obligations, shifting the focus from the Natural Gas Act and the certificates issued under it, to the private contract entered into between the producer and the pipeline. Thus, the FPC stated that in its earlier Order 539, it had intended to inform producers that once deliveries were commenced in interstate commerce under certificated arrangements, "such deliveries continue without unjustifiable unilateral interruption in accordance with the applicable provisions of the contract." (Emphasis added.) R.398. 16/

15/ Order 539-A, 41 Fed. Reg. 14531 (Apr. 6, 1976), R.394.

16/ See also similar characterization at R.395.

The FPC also gave notice in Order 539-A of a rulemaking proceeding designed to gather information concerning the obligation of "parties accepting a certificate of public convenience and necessity from this Commission," and of its intention to amend § 2.83 accordingly. R.403. In these subsequent proceedings, the producers reiterated their earlier claim that FPC enforcement would violate § 1(b) of the Natural Gas Act. 17/ And in response to the FPC shift of direction from the certificate to the contract, the producers replied that, by and large, the underlying producer-pipeline contract contained no firm delivery obligations. Rather, the producers asserted that under their contracts they retained "sole discretion" regarding the rate of delivery. 18/ Petitioner, for its

17/ See, e.g., R. at 178, 314, 360-61, 371-80, 655-56, 661-68, 669, 24-25.

18/ See, e.g., R. at 175, 312-13, 364-65, 660-61, 669, 20, 29, 68, 74. There is no evidence in the record that the FPC ever investigated this claim. In briefing before the court of appeals, petitioner made an effort to review a cross section of producer-pipeline contracts and found a substantial variation, with some containing "sole discretion" terms (footnote continued)



part, urged the FPC to return to the policy set forth in Order 539 -- that certificate obligations take precedence over contract terms -- and to measure the certificate obligation by the level of service actually provided. Alternatively, petitioner suggested that the obligations might be determined by reference to various representations made in the course of producer or pipeline certifications. 19/

(footnote continued) and others containing firm obligations, often building in adjustments based on reserve determinations. Brief for Petitioner, Consumer Federation of America, at 20-23. If any generalization can be made on the basis of this sample, it is that more recent contracts give producers more discretion, probably reflecting their prevailing bargaining power in days of shorter supply.

19/ At the time of certification, a producer applicant must submit its gas supply contract and a map of the dedicated field. 18 C.F.R. § 157.25. The pipeline applicant must also submit detailed estimates of gas deliverability and proved reserves. 18 C.F.R. 157.14(a)(10). Deliverability, for these purposes:

> represents the number of future years during which

(footnote continued)

Following the hearing, on July 30, 1976, the FPC issued Order 539-B to "clarify" its prior orders. Pet. App. B, p. 22a. Despite the fact that the notice of rulemaking provided by Order 539-A had indicated a purpose simply to "amend" § 2.83 of the FPC's General Policy and Interpretations, Order 539-B repealed that section entirely, including the reporting and approval requirements found in § 2.83(d). Pet. App. B, p. 22a. In its place, the FPC enacted a new section -- § 157.41 -- of its Regulations. Pet. App. B, p. 23a.

With this abrupt change, the FPC abandoned entirely the approach set forth in § 2.83 which focused upon the Act, and the duties imposed

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(footnote continued)

a pipeline company can meet its annual requirements for its presently certificated delivery capacity from presently committed sources of supply. The availability of gas from these sources of supply shall be governed by the physical capabilities of these sources to deliver gas, by the terms of existing gas purchase contracts and limitations imposed by state or federal regulatory agencies.

29 Fed. Reg. 4874 n.1 (Apr. 7, 1964).



under it; instead the agency endorsed the contract between the producer and pipeline as establishing the contours of certificated obligations, and imposed a further contract concept -- "prudent" operation. Pet. App. B, p. 17a. The Order stated that the prudent operator standard was adopted not because it reflected producer service obligations stemming from the certificates, but essentially because it was a standard with which producers were "acquainted," from their own private lease arrangements and from state and federal laws relating largely to conservation. Pet. App. B, p. 17a.

Immediately following issuance of Order 539-B, Shell Oil Company petitioned for review in the Fifth Circuit. Petitioner filed a petition for review in the D.C. Circuit, which promptly transferred the action to the Fifth Circuit pursuant to 28 U.S.C. § 2112. Oral argument was held before the court of appeals on July 6, 1976. On January 20, 1978, the court of appeals issued its opinion, declaring Order 539-B's prudent operator standard invalid, as contravening the jurisdictional exemption for production and gathering activities contained in Section 1(b) of the Natural Gas Act. Although recognizing that under prior holdings of this Court the Commission has jurisdiction to "enforce 'service

obligations' contained in certificates that it issues to producers [in order to prevent] producers from ceasing deliveries from fields . . . capable of continuing production," Pet. App. A, p. 7a, the court concluded that Order 539-B "clearly is intended to open the door to FERC involvement into forbidden production activities." Pet. App. A, p. 9a. In so holding, the court of appeals did not explain how the Commission might effectively exercise its admitted certificate enforcement powers.

3. Impact of the Natural Gas Policy Act

Since the issuance of Order 539-B and the decision of the court of appeals, Congress has passed, and the President has signed, new legislation designed to bring about the phased deregulation of certain categories of natural gas. Natural Gas Policy Act of 1978 ("NGPA"), Pub. L. No. 95-621. Briefly summarized, the NGPA withdraws from the Commission's jurisdiction under the Natural Gas Act all natural gas which was not committed or dedicated to interstate commerce as of the day before the date of enactment of the NGPA. However, with the exception of limited categories of already dedicated gas which might qualify



as "new" gas under the NGPA, 20/ all natural gas presently dedicated to interstate commerce remains within the jurisdiction of the Commission, under a statutory pricing mechanism tied to the Commission's current "just and reasonable" rates.

The total volume of gas remaining in these dedicated gas reserves was estimated at the close of 1976 to be 98.3 trillion cubic feet, nearly nine times the amount of gas delivered from those reserves during

20/ In the context of the instant case, the most significant of these categories are "new natural gas" and "natural gas produced from any new, onshore production well." The category of "new natural gas," NGPA § 102, includes any gas produced from a new well which is drilled 2.5 miles or more away from the nearest well which produced gas in commercial quantities between January 1, 1970 and April 20, 1977. The category of gas produced from "new, onshore production wells," NGPA § 103, includes any gas from a new well located onshore, surface drilling of which commenced on or after February 19, 1977, which satisfies State and federal wellspacing requirements, if any, and which is not located within certain "proration units" (i.e., portions of a reservoir which will be effectively and efficiently (footnote continued)

the preceeding year. 21/ Moreover, a FERC analysis submitted to the Senate Committee on Energy and Natural Resources during Congressional deliberations stated:

> The bulk of gas which will serve interstate consumers is in the [already dedicated or committed] category, and will remain subject to the Commission's nonprice jurisdiction. 22/

(footnote continued)
drained by a single well).
For a description of the resulting rate structure, see n. 23, p. 21, infra.

21/ FERC, The Gas Supplies of Interstate Natural Gas Pipeline Companies 1976, at 3, 6-7 (1978).

22/ Letter of Charles B. Curtis, Chairman, FERC, to Senator Henry M. Jackson, Chairman, Senate Committee on Energy and Natural Resources (Sept. 8, 1978), attached analysis at 86. See also Department of Energy Division of Oil and Gas Analysis: Office of Energy Source Analysis, Analysis Memorandum AM/ES/7801: Revenues to Natural Gas Producers Under Alternative Regulatory Assumptions, at 24-25 (June 12, 1978)(hereinafter "DOE Memorandum"); 124 Cong. Rec. at
(footnote continued)



The sheer volume of dedicated gas which remains subject to Commission jurisdiction under the Natural Gas Act shows the need for an unequivocal affirmation by this Court of the Commission's authority to assure delivery of that gas.

The need for such an affirmation is enhanced by the pricing system imposed by the NGPA. That system provides a mechanism for establishing the price of various categories of gas, "new" and "old," interstate and intrastate. The statutory rates for "old" gas are largely derived from present regulated rates. Ceiling prices for "new" gas and sales under existing intrastate contracts, by contrast, are substantially higher. 23/ And as of January 1, 1985, price ceilings will be eliminated totally for most categories of natural gas, with the exception of "old" gas. NGPA § 121.

(footnote continued)
H13239, H13243 (Oct. 14, 1978) (Congressional Budget Office estimated only 3% increase in production by 1985 as a result of NGPA).

23/ Therefore, for "new natural gas," NGPA § 102, the maximum price is calculated by establishing a $1.75 base price for April 1977, and increasing it by both a monthly inflation adjustment factor and an annual escalator of 3.5 or 4 percent.
(footnote continued)

While the NGPA is thus clearly designed to assure that consumers continue to benefit from the lower prices attached to presently dedi-

(footnote continued)
"New, onshore production well" gas, NGPA § 103, is increased from an April 1977 level of $1.75 by means of a monthly inflation factor only. However, gas dedicated to interstate commerce before the date of enactment not only starts at a lower "base rate" for April 1977 (i.e., generally the base rate is the "just and reasonable" rate previously set for such gas by the Commission), but also is increased only by a monthly inflation factor. As a result, the estimated maximum ceiling prices for these three categories as of October 1978 would be $2.07 (new natural gas), $1.97 (new, onshore) and either $1.63, $1.06, or $.33 for dedicated gas. Because rates will be recomputed monthly, the gap between these categories will grow over time. FERC Office of Public Information, Fact Sheet: Natural Gas Policy Act of 1978 (1978)(attached table). See also DOE Memorandum, supra at 24-25.



cated supplies, 24/ the act itself also creates obvious incentives which, if unchecked by careful exercise of Commission power, might result in the diversion of these dedicated reserves to gradually unregulated categories, which are allowed higher ceiling prices under the NGPA. The existence of such incentives renders the need for careful consideration by this Court especially critical.

24/ See, e.g., 124 Cong. Rec. at H13242 (Oct. 14, 1978)(Statement of Rep. Sharp, Manager on part of the House in Conference Committee):

> [W]e put the highest incentive where the highest risks are and where the greatest gains might come from. The next highest incentives are where there are new gas supplies and major risks . . .
>
> We tried to see to it that we were protecting the consumer from paying the highest prices where it was not deserved. (emphasis added).

## ARGUMENT

In Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), this Court made it clear that independent producers of natural gas are subject to the Commission's jurisdiction under the Natural Gas Act. As a result, any producer who wishes to sell gas in the interstate market must obtain a certificate of public convenience and necessity from the Commission. The question in this case is what, if any, delivery obligations are imposed on a producer by and under the Act, when the producer accepts such a certificate and commences interstate service. And, if delivery obligations are so imposed, the question then is, whether and how those obligations may be enforced.

The Commission in Order 539-B would measure producer delivery obligations by a prudent operator standard. The producers have attacked this standard on both jurisdictional and substantive grounds. On jurisdictional grounds, they argue that the standard invades the production and gathering exemption in § 1(b) of the Act. On substantive grounds, they argue, in effect, that the certificates impose no independent delivery obligations, and further, that supply contracts with the pipelines contain no firm requirements as to the rate of delivery.



The Commission and petitioner, by contrast, agree that § 1(b) cannot be read to nullify all the provisions of the Act designed to assure consumers an adequate, reliable supply of gas. The Commission and petitioner also agree that the certificates impose delivery obligations separate from, and in addition to, the obligations in producer-pipeline contracts. Disagreement centers on the measure of those obligations, and the mechanism which should be adopted to enforce them.

The court of appeals invalidated the Commission's prudent operator standard on jurisdictional grounds, thus diverting attention from the underlying issue concerning the substantive obligations imposed by the Act. This threshold jurisdictional question is, of course, critically important, since a broad interpretation of the § 1(b) exemption renders discussion of standards and enforcement largely moot. We submit that the court of appeals' decision is in conflict both with the scheme and purpose of the Act, and with this Court's decisions construing the Act. We also believe, however, that the FPC unwittingly aided the producers in their jurisdictional challenge. It did so by articulating a standard which focuses directly upon the operations of the producer, rather than upon service rendered.

Had the standard focused upon service, production and gathering activity would only be of incidental concern, as a possible justification for declining deliveries. In that event, surely there could be no colorable challenge to the Com..ssion's jurisdiction.

While we do not see Order 539-B's focus on producer operations as a fatal jurisdictional flaw, we submit that the standard does otherwise violate the Natural Gas Act. It is to this substantive failing of the standard that we devote most of our attention.

The terms of Order 539-B indicate that the FPC drew the prudent operator standard from two areas of the law familiar to producers, but foreign to the purposes of the Act. As for enforcement, the Order articulates no procedures or approach. We submit that the Natural Gas Act requires more. It requires a standard reflecting the Act's fundamental concern for maintenance of service. It requires a standard that is free from vagueness, and gives producers, consumers and Commission staff concrete guidance as to the supply obligations imposed by the Natural Gas Act. And it requires a standard that is enforceable.



## I. THE STANDARD GOVERNING DELIVERY OF NATURAL GAS UNDER A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY MUST REFLECT THE "SERVICE" CONCERNS OF THE NATURAL GAS ACT AND MUST BE UNAMBIGUOUS AND ENFORCEABLE.

### A. Continuity Of Service Is The Key To Producers' Delivery Obligations.

Only last May, this Court reaffirmed that the fundamental purpose of the Natural Gas Act is to assure the consumer "an adequate and reliable supply of gas at a reasonable price." California v. Southland Royalty Co., 98 S. Ct. 1955, 1958 (1978). In prior years, it was perhaps sufficient for the focus of regulation to be upon the reasonableness of the price charged. Today, however, it has become clear that regulation cannot be limited to assuring reasonable rates. The focus of attention must turn from rates to supply and service, for the dual purpose of the Natural Gas Act is not fulfilled if the public receives only an inadequate or unreliable flow of gas at a reasonable price.

As this Court said in the landmark case of Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137, 155 (1960), there are "two sources of

. . . supply stability inherent in the regulatory system established by the Natural Gas Act -- the provisions of private contracts and the public regulatory power." The first source of protection for the consumer then, is the contract of the parties. This was recognized in United Gas Pipe Line Co. v. Mobil Gas Service Corp., 350 U.S. 332 (1956), where the contract of the parties established a single fixed rate, but the seller attempted to file a rate change with the Commission under § 4(d) of the Natural Gas Act, 15 U.S.C. § 717c(d). This Court held that the Natural Gas Act did not confer upon the seller the right to thus avoid its contractual obligation. So too in the instant case, it should be recognized from the outset that to the extent the private contractual undertakings of the parties provide a fixed obligation that assures the public of reliable service, that undertaking cannot be avoided.

On the other hand, this Court has long recognized that where private contractual arrangements do not assure a steady and reliable supply of gas, the terms of the Act come into play to fill the gap. Sunray Mid-Continent Oil Co. v. FPC, supra, and Sun Oil Co. v. FPC, 364 U.S. 170 (1960) so hold. Moreover, analysis of the principles which were laid down



in Sunray and Sun Oil, and confirmed recently in California v. Southland Royalty Co., supra, leads to the conclusion that continuity of service is a central concern of the Act, and that the maintenance of such service must therefore be the ultimate test of the producers' delivery obligations under certificates of public convenience and necessity.

Under § 7(c) of the Act, 15 U.S.C. § 717f(c), all natural gas companies must obtain a certificate of public convenience and necessity from the Commission before engaging in the interstate supply of natural gas. In order to obtain a certificate, an applicant must demonstrate that it is "able and willing properly to do the acts and to perform the service proposed," 15 U.S.C. § 717f(e), and to this end, a producer applicant must submit its gas supply contract. In both Sunray and Sun Oil, the producer submitted a contract of limited duration in applying for a certificate of public convenience and necessity; in each case, the FPC issued a certificate which was silent as to duration. In Sunray, the producers argued that the FPC could not issue a certificate of unlimited duration; and in Sun Oil the producers argued as well that the FPC had not issued certificates of unlimited duration. In both cases, the producers maintained that their obligations were

defined solely by their contracts, and that "the Natural Gas Act does not vest the Commission with broad powers to assure continuity of service." (Brief of Petitioner, Sunray Mid-Continent Oil Co., at 18, in Sunray Mid-Continent Oil Co. v. FPC, supra.) The FPC, by contrast, argued that the issuance of a certificate did not amount to the adoption of a contract for a specific number of years, nor to the adoption of a "sale" of a "specific volume" or "batch" of gas. Rather, the issuance of a certificate amounted to an authorization to perform a "supply service which, once started is the subject of continuing . . . regulation and may continue independently of the parties' contract." (Brief of Respondent Federal Power Commission at 15, in Sun Oil Co. v. FPC, supra (citation omitted).) Thus, there resulted a fundamental clash as to the nature of the producers' obligations and the extent of the FPC's powers under the Natural Gas Act.

This Court adopted the view urged by the Government. Despite the silence of the certificate on the issue, it was implicit in the structure and purpose of the Act that in granting a certificate, the Commission was not adopting the underlying contract but rather, was authorizing a service which would



thereafter continue subject to the Commission's supervision. Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. at 151-56.

An important factor in the Court's analysis was section 7(b) of the Act, 15 U.S.C. § 717f(b). Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. at 141-43. Section 7(b) provides that "[n]o natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities" unless the Commission first determines "that the available supply of natural gas is depleted to the extent that continuance of service is unwarranted, or that present or future public convenience or necessity permit such abandonment." (Emphasis added.) The reach and purpose of § 7(b) are clear. As the Third Circuit had earlier observed in denying abandonment authorization to a producer relying upon an escape clause in the certificated contract:

> [M]ost important, service to the public was the foundation of the contract operation. That service was given. The public relied on it through the years and is entitled to its fair continuance. To abandon it there must be Commission approval. J.M.

Huber Corp. v. FPC, 236 F.2d 550, 558 (3rd Cir. 1956), cert. denied, 352 U.S. 971 (1957). (Emphasis added.)

Indeed, in Sunray, this Court too noted its concern that a " local economy which had grown dependent on natural gas as a fuel" not be suddenly left without service. Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. at 143.

Case after case can be found to the same effect. See generally, Conine, G., and Niebrugge, T., Dedication Under the Natural Gas Act, 30 Okla. L. Rev. 735, 772-833 (1977). Most of the service cases have been decided under section 7 of the Act. However, the Natural Gas Act's concern over maintenance of service is also exhibited in another section, § 4, and in particular § 4(d), 15 U.S.C. § 717c(d). Section 4(d) provides that "[u]nless the Commission otherwise orders, no change shall be made by any natural-gas company in any . . . service . . . except after thirty days' notice to the Commission and to the public." Any such change in service is subject to review by the Commission under § 4(e), 15 U.S.C. § 717c(e).

The purpose of § 4(d) in regulating producer discretion and assuring stability and reliability is well-established in the price arena. Producer gas sales contracts invariably



include price escalation clauses. Accordingly, when in 1954, the producers were first subjected to regulation under the Act, Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), they argued that these price escalation provisions relieved them of any duty to file for a change of rate under § 4(d). This argument was uniformly rejected by the courts. Episcopal Theological Seminary v. FPC, 269 F.2d 228 (D.C. Cir.), cert. denied, sub nom. Pan American Petroleum Corp. v. FPC, 361 U.S. 895 (1959); Bel Oil Corp. v. FPC, 255 F.2d 548 (5th Cir.), cert. denied, 358 U.S. 804 (1958); Cities Service Gas Producing Co. v. FPC, 233 F.2d 726 (10th Cir.), cert. denied, 352 U.S. 911 (1956).

Clearly, the problem of price escalation is first cousin to the problem of service de-escalation. Whereas under price escalation clauses, the producers argued that they could increase prices at will, so here, under the "sole discretion" clauses of their contracts, they now effectively argue that they can decrease service at will. 25/

25/ In light of the higher prices available for "new" gas and intrastate gas under the NGPA, a decrease in service under Commission certificates in fact allows an increase in price through the sale of noncerti-
(footnote continued)

However, in the same manner that the Act protects the public from contractually permissible price increases, so too the Act protects the public from contractually permissible service decreases. 26/ This was recognized by the Court in Sunray, supra 364 U.S. at 156:

(footnote continued)
ficated gas. See pp. 21-22 supra.

26/ It should be noted that when a contract allows flexibility to one party, and the Commission in enforcing the Act nevertheless imposes a requirement of stability, the Commission is not requiring the party to violate obligations under the contract. It should also be noted, however, that in enforcing the Act, the Commission can, if necessary, require a party to disregard contractual obligations. Indeed, the Court only recently upheld the Commission's authority to do so in the context of curtailment. See FPC v. Louisiana Power & Light Co., 406 U.S. at 646-47. See also FPC v. Sierra Pacific Power Co., 350 U.S. 348 (1956), where the Court recognized the FPC's power to authorize rate increases despite contractual limitations to the contrary. And see Permian Basin Area Rate Cases, 390 U.S. 747, 763-64 (1968), where the Commission
(footnote continued)



> [O]nce . . . dedicated, there can be no withdrawal of [a] supply of gas from continued interstate movement without Commission approval. The gas operator, although to this extent a captive subject to the jurisdiction of the Commission, is not without remedy to protect himself. That remedy he has . . . in the "change" power under § 4(d) when his contract has expired or where his contract permits its use during its term. Under a similar Act this Court has held to the same effect as we hold today. Pennsylvania Water & Power Co. v. Federal Power Comm'n, 343 U.S. 414, 423-44. 27/ (Citation omitted.)

(footnote continued)
imposed a minimum area rate which allowed producers to raise their prices notwithstanding the lower prices provided by the producer-pipeline contracts. Not surprisingly, none of the producers in Permian Basin objected to the minimum rate, even though it was inconsistent with their contracts.

27/ The Court's reference to Pennsylvania Water & Power Co. further illustrates § 4(d)'s concern
(footnote continued)

The Commission's regulations also reflect the scope of § 4(d). Thus, under 18 C.F.R. § 154.94(a), no change in "service" can be made without filing a change in rates pursuant to § 4(d) of the Act. And pursuant to 18 C.F.R. § 154.94(c):

> (c) The operation of any provision of the rate schedule providing for future or periodic changes in . . . service . . . shall constitute a change in rate schedule.

(footnote continued)
with maintenance of service, absent approval of declining deliveries. In that case, in construing § 205(d) of the Federal Power Act, 16 U.S.C. § 824d, a section almost identical in wording to section 4(d) of the Natural Gas Act, this Court stated that "[i]f Penn Water wishes to discontinue some or all of the services it has rendered for the past twenty years, the Act, as the Commission pointed out, opens up a way provided Penn Water can prove that its wishes are consistent with the public interest." 343 U.S. at 423. The way for Penn Water to proceed, said the Court, was to ask permission for a change of existing services pursuant to § 205(d). Id. at 424.



It is therefore apparent that maintenance of service is at the core of the obligations undertaken by a producer in applying for a certificate of public convenience and necessity. Indeed, the view we urge here seems to follow logically from Sunray and Southland Royalty Co. Surely it would have made little difference if Sunray or Southland, rather than attempting to cease interstate deliveries from dedicated reserves, had simply cut those deliveries by half. Nor, we submit, would their positions have been enhanced if they had pointed to a "sole discretion" clause in the delivery contract. In either case, we believe the Court would have focused directly on prior service and required the Commission to regulate any effort to curtail that service.

### B. The Prudent Operator Standard Is Invalid Because It Is Not A Service-Oriented Standard.

Given, then, that service is the central theme of the Natural Gas Act in this area, and that the Commission has both the power and the concomitant duty to protect the public from unwarranted reductions in service, where does Order 539-B go wrong? The Order speaks of service. It faithfully cites the

sections of the Act relating to service, as justification for the standard adopted. Pet. App. B, pp. 13a, 15a, 16a. It is thus well cushioned in all the right language. Yet, notwithstanding this litany, the standard does not look to service rendered in determining the producer's continuing obligation. Rather, the standard is based on concepts which bear no relation to service. 28/

As the FPC indicated, Pet. App. B, pp. 16a, 17a, the prudent operator standard is derived essentially from two sources: first, the law governing the relation between the producer and the owner of the land from which gas is extracted; and second, state and federal laws which relate largely to conservation. 29/ Neither

28/ Indeed, in describing the actual operation of the prudent operator standard, the FPC made no further mention of "service." Pet. App. B, pp. 16a-18a. Moreover, the Order wholly ignores the procedures under the Act for enforcing producers' service obligations, § 4(d), § 4(e) and § 7 (b). 15 U.S.C. §§ 717c(d), 717c(e), 717f(b).

29/ Although the Order also states that the FPC has historically reviewed natural gas companies' actions on the basis of prudence, its sole citation for this proposition is FPC (footnote continued)



source is concerned with assuring that consumers receive an adequate and reliable supply of gas. Indeed, it can be demonstrated that both these areas of the law are designed to serve purposes distinct from, and in large measure, actually in conflict with the purposes of the Natural Gas Act.

Let us look first at the law governing the producer's lease agreement. A producer typically obtains the right to explore for and produce natural gas by negotiating a lease with the landowner, and paying the landowner a royalty for the gas produced from that land. An implied condition in any such lease is that the producer explore, develop, and market as a prudent operator would. The purpose of implying a prudent operator standard in this lease agreement was explained in the seminal case of Brewster v. Lanyon Zinc Co., 140 F. 801, 810-11 (8th Cir. 1905). It was to ensure that in the extraction of gas, "work should be along such lines as would be

(footnote continued)
v. Natural Gas Pipeline Co., 315 U.S. 575 (1942). Pet. App., p. 16a. That case, however, deals exclusively with the reasonableness of rates and fair returns on investment under sections of the Natural Gas Act which expressly refer to the consideration of reasonableness.

reasonably calculated to effectuate the controlling intention of the parties as manifested in the lease, which was to make the extraction of oil and gas from the premises of mutual advantage and profit." Obviously, what may be to the mutual advantage and profit of the producer and his lessor may not be to the similar advantage of users relying on the interstate transportation of gas. Indeed, the interests of the producer and his lessor may be diametrically opposed to those of the consumer.

For example, the treatise cited by Order 539-B, Pet. App. p. 16a, breaks the prudent operator standard into a number of implied covenants. See H. Williams and C. Meyers, Oil and Gas Law § 802.3 at 14.2 (1976). Among those covenants are the covenants to drill exploratory wells, to develop the premises, and to market the product. In discussing this latter covenant, in § 856.3 at 409-10, the treatise makes clear that a prudent operator may be justified in delaying the marketing of his product if he thinks he can thereby get a better price for it. The treatise then goes on to point out that "the same type of good faith judgment may be involved in a decision by the lessee to delay the execution of a gas sales contract until he can find an intrastate market, rather than an



interstate market, for the gas." Id. at 410. A standard based on such considerations is hardly tailored to ensure the interstate service certificated by the Commission and relied upon by a myriad of users.

Nor are the service ends of the Natural Gas Act furthered by resort to those state or federal laws which relate to conservation. Because of the peculiar nature of gas production, when gas is extracted too rapidly, waste may occur. See Interstate Oil Compact Commission, Oil and Gas Production, at 112-13 (1969). State and federal laws have been enacted to prevent such waste. They often set an upper limit on rates of production. They do not, however, set a lower limit. See Initial Decision in FERC Docket RI 75-112 at 83, July 7, 1978. If then, a producer had financial incentives to slow production more than would be necessary to prevent waste, these laws would provide no assistance in holding the producer to the fulfillment of his service obligation.

This is not the first time the Commission has tied its regulation to a concept totally foreign to the scheme of the Act. In FPC v. Texaco, Inc., 417 U.S. 392, 397-99 (1974), to this Court's obvious dismay, the Commission tied a supposedly

regulated rate to the going market price. What the Commission has done here is no less incongruous, for the prudent operator standard is no better designed to assure continuing service within the meaning of the Natural Gas Act than the marketplace standard was designed to assure "reasonable" rates.

The result reached by the FPC may in part be explained by the course of action it followed in arriving at the prudent operator standard. After dismissing the producers' contention that their contracts with the pipelines permit them virtually unfettered control over deliverability, Pet. App. B, pp. 13a, 14a, the Commission did not look more carefully at those contracts, 30/ or consider the relevance of past reliance upon the continuing delivery obligation. Nor did it examine the certification process to see what guidance the various undertakings or submissions there might provide in defining "certificated obligations." Instead,

30/ The Commission seems by and large to have contented itself with the producers' characterization of their contractual obligations. See, e.g., the discussion in Order 539-B regarding "minimum daily delivery obligations," where the Commission simply stated "we must conclude that
(footnote continued)



the Commission reached outside the certification process, drawing the concept of "prudent operation" from private lease agreements and laws relating to conservation. Having identified the circumstances in which this concept had been used, the Commission simply concluded that the standard was appropriate because "all producers are acquainted" with it. Pet. App. B., p. 17a. In so doing, the Commission strayed both from the purposes of the Act, and from its task of construing and enforcing the Act's terms. See Sunray Mid-Continent Oil Co. v. FPC, supra; Sun Oil Co. v. FPC, supra.

### C. The Prudent Operator Standard Is Also Invalid Because It Is Vague And Unenforceable.

Perhaps because it represents a standard neither derived from nor responsive to the Act's purposes, the "prudent operator" approach is both vague and unenforceable. If, as the Commission concedes, there is a need to assure that producers meet

(footnote continued)
the clause is not one that has a generally accepted meaning among pipelines and producers."
Pet. App. B, p. 12a.

their certificated delivery obligations, the "prudent operator" standard of Order 539-B will not -- indeed, cannot -- satisfy that need. For this additional reason, it should be set aside.

The issue of vagueness must be evaluated in context. The context, as discussed earlier, is a network of pipelines, utilities and end users who depend upon a continuing supply of gas from dedicated fields, and who have made major investments in reliance upon that supply. What those users need, above all, is some precise and predictable measure of the producer's obligations. A standard of "prudence," with no specific guidance as to what factors will be relevant in its application, provides no such measure.

A standard so vague not only disregards the public's needs; it also disregards statutory intent. This would be glaringly apparent if the problem addressed had been one of price, rather than one of supply, because the FPC surely could not have discharged its duty to regulate rates by simply admonishing the producers that their prices should be just and reasonable. In fact, the FPC generally did not take its mandate to regulate rates so lightly. Rather, as the proceeding in Permian Basin illustrates, the FPC worked



hard to develop manageable ways of monitoring the producers' activities in the rate area. See Permian Basin Area Rate Cases, 390 U.S. 747 (1968). Moreover, in the one instance where the FPC did promulgate a ratemaking order that was so vague as to amount to effective price deregulation, this Court did not hesitate to overturn that order. FPC v. Texaco, Inc., 417 U.S. at 395-97.

The Natural Gas Act was intended to provide not only reasonable rates, but also adequate and reliable service. Yet, in stark contrast to the manner in which it regulated rates, the FPC did not try to develop a concrete, manageable standard to gauge service obligations. Instead, it relied upon a single unelaborated exhortation to those who control the supply of gas that the public depends upon, to act "prudently." The fluid nature of this "reasonableness" standard simply defies predictability, at a time when a precise, definite standard, with an assured enforcement mechanism is needed. Like the Order in FPC v. Texaco, Inc., Order 539-B is, as written, fatally vague.

Moreover, the FPC subsequently added ambiguity to vagueness, thus further undermining Order 539-B. When it first promulgated the Order, the FPC suggested that the standard was administrable because producers were

"acquainted" with it. However, as the agency came to recognize that the prudent operator standard's origins poorly suited it to the purposes of the Natural Gas Act, the FPC modified its position, and argued that the standard would not, in fact, be the one with which producers were acquainted. Thus, in its brief to the Fifth Circuit, the FPC admitted that "due to public interest considerations," it could not enforce "exactly the prudent operator standard used by a lessor or purchaser." Brief of Respondent Federal Power Commission at 25.

From this condition of vagueness and ambiguity comes Order 539-B's most serious defect -- the utter impossibility of enforcement. Because of its lack of guidance and confusing origins and purpose, the prudent operator standard must defy application. The matter is made worse by the fact that the standard will require an individualized look at the activities of each producer and the conditions in each field. 31/

31/ We do not mean that such factors are irrelevant under a proper standard, but that by starting with a "service" standard the producer would be required to raise these factors in their proper place -- as justification for declining deliveries. See discussion on pp. 48-49, 58, infra.



In reality, such a standard can only result in a few time-consuming and complex proceedings which will exhaust the Commission's limited enforcement resources, without providing the adequate and reliable service the Act was designed to ensure.

In light of the FPC's history in the rate area, the agency's resort to the "prudent operator" standard is all the more disturbing. It was the very impossibility of making a reasonableness determination on a case by case basis that eventually led the FPC to adopt, first area rates, and then national rates for producer sales. See Permian Basin Area Rate Cases, 390 U.S. at 755-59; Shell Oil Co. v. FPC, 520 F.2d 1061 (5th Cir. 1975), cert. denied sub nom. California Co. v. FPC, 426 U.S. 941 (1976). Indeed, it was the backlog caused by individualized scrutiny of producer rates that resulted in what was called in 1960 the "outstanding example in the federal government of the breakdown of the administrative process." Landis, Report on Regulatory Agencies to the President-Elect, printed for use of the Senate Committee on the Judiciary, 86th Cong., 2d Sess., 54. Surely, then, experience has proven that a precise, repeatable and easily applied standard is needed to regulate natural gas producers under the Act.

We would not presume to dictate to the Commission the precise manner in which it must regulate producers' delivery obligations. The Commission has the necessary expertise, as exhibited in a long history of rate regulation. 32/ Although regulating supply may pose problems different from those posed by ratemaking, these problems are surely not insoluble. For example, using the Act's touchstone of service, and a proper reporting 33/ and approval procedure

32/ The agency found a very concrete and unambiguous way to deal with price escalation clauses -- it simply placed an upper lid on them, notwithstanding the producers' objections that the contracts provided no such ceiling. Permian Basin Area Rate Cases, 390 U.S. at 764, 781-84.

The Commission has also made full use of the tools available to it in regulating curtailments of service. See generally, M. Willrich, Administration of Energy Shortages, at 41-108 (1976).

33/ The Commission already receives substantial data from both producers and pipelines. See, e.g., 18 C.F.R. § 260.1 ("Form 2); 18 C.F.R. § 260.7 ("Form 15"); and Order No. 526-C, issued Feb. 17, 1978 ("Form 40"). To the extent that existing reports are not sufficient, the Commission could easily require the pipelines to (footnote continued)



(drawing upon § 4(d), § 4(e), and § 7(b) of the Act), the agency could devise an effective mechanism for monitoring declines in producer deliveries. Applying its expertise, the Commission should be able to develop a workable system of review, tailored to the realities of its limited manpower and designed to place a minimum burden on the industry. It might decide, on the basis of historical trends, that declining supplies within a certain range should be automatically approved and that its attention should focus only on those situations where the data flow indicates that a producer has been experiencing "abnormal" declines. Similarly, it might decide to focus its resources principally on the largest producers.

Clearly, then, there are manageable solutions in the supply arena.

(footnote continued)
submit additional data that would make it possible to trace over time deliveries received under each certificated obligation.

Moreover, as we argued before the court of appeals, this data flow, particularly the reserve and deliverability estimates submitted by the pipeline at the time of application and updates thereafter (see n.19, pp. 15-16 supra), could also play a role in establishing the service standard itself.

The Commission could, if called upon to do so, develop a regulatory scheme faithful to the purposes of the Natural Gas Act, reflecting a standard and enforcement mechanism designed to assure that consumers receive reliable service at reasonable rates.

## II. THE "PRODUCTION AND GATHERING" EXEMPTION TO THE NATURAL GAS ACT DOES NOT PRECLUDE THE COMMISSION FROM ENFORCING PRODUCER DELIVERY OBLIGATIONS UNDER AN APPROPRIATE STANDARD.

In addressing the jurisdictional question, we do not defend Order 539-B's prudent operator standard. As indicated above, we believe it is illegal for other reasons. However, it is apparent from the history of this proceeding that the industry is prepared to resist on jurisdictional grounds any effort to enforce delivery obligations, whatever the standard or mechanism adopted. 34/ Moreover, while the court of appeals seemed to indicate that enforcement could proceed under a proper standard, Pet. App. A, p. 7a, its opinion neverthe-

34/ See R. 573, 361, 362, 662, 667.



less casts a pall over the Commission's authority in this area. It is thus extremely important for the Court to resolve this issue in such a fashion as to leave no question concerning the Commission's jurisdiction under an appropriate enforcement program.

As discussed above, any company wishing to sell natural gas in the interstate market must obtain from the Commission a certificate of public convenience and necessity. Any company thereafter wishing to change or discontinue service must obtain authorization from the Commission pursuant to § 4(d) or § 7(b). Notably, however, proceedings under those sections are initiated by the company, as it is the company which must seek Commission approval for a change or abandonment of service. But at the time Order 539-B was promulgated, natural gas producers were reducing, and in some cases even abandoning, service without seeking Commission approval. See, e.g., McCombs v. FERC, 570 F.2d 1376, 1379 (10th Cir. 1978), cert. granted, 47 U.S.L.W. 3240 (Oct. 10, 1978). The jurisdictional question which this Court must now decide is whether § 1(b) of the Act leaves the Commission powerless to prevent such action.

It would seem from the very scheme of the Act -- the process of certifi-

cation, with the express requirements of Commission approval of alterations -- that the Commission must have the authority to enforce the obligations it certificates. Moreover, as this Court recently recognized in upholding the FPC's power to order curtailment of service under § 4, "'the Commission's broad responsibilities . . . demand a generous construction of its statutory authority . . .'" and it "must possess broad powers to devise effective means to meet these responsibilities . . . ." FPC v. Louisiana Power & Light Co., 406 U.S. at 642, quoting in part from Permian Basin Area Rate Cases, 390 U.S. at 776. See also FPC v. Texaco, Inc., 417 U.S. at 388-89; United Gas Pipe Line Co. v. FPC, 385 U.S. 83, 89-90 (1966). Surely, the Commission's authority to assure consumers service under the Natural Gas Act is as broad as its authority to curtail that service. Yet it is now suggested that due to § 1(b) of the Act, the Commission cannot effectively exercise this authority.

In the same decision in which this Court upheld the broad power of the Commission to direct curtailment, the Court also grappled with § 1(b) of the Act. See FPC v. Louisiana Power & Light Co., 406 U.S. at 631-41. In that case, a utility company which stood to benefit if the FPC's curtail-



ment authority were narrowly construed, argued that the "direct sales" exemption of § 1(b) prevented the FPC from directing curtailment of its gas. Had the Court accepted the company's argument, the FPC's curtailment program would have been seriously undermined -- to the great benefit of a few fortunate users in some producing states, but to the enormous detriment of the rest of the nation. Recognizing this, the Court rejected the company's construction of the exemption. As in Louisiana Power, the Court is again asked to construe a narrow exemption under § 1(b). This time, however, the construction proffered is not one which merely undermines the Commission's authority to allocate gas supplies. Rather, the argument made is one which could deprive the Commission of the power to ensure the interstate transmission of any supply at all.

The exemption which the producers would use for this task is not the direct sales exemption in question in Louisiana Power, but the "production and gathering" exemption in the same § 1(b) proviso which the Court in Louisiana Power described as follows:

> It is well established that the proviso was added to the Act merely for clarification

and was not intended to deprive the FPC of any jurisdiction otherwise granted by § 1(b). FPC v. Transcontinental Gas Pipe Line Co., 365 U.S. 1 (1961); FPC v. East Ohio Gas Co., 338 U.S. 464 (1950). The House Report on the bill described this second sentence of § 1(b) as follows:

> "The quoted words are not actually necessary, as the matters specified therein could not be said fairly to be covered by the language affirmatively stating the jurisdiction of the Commission, but similar language was in previous bills, and, rather than invite the contention, however unfounded, that the elimination of the negative language would broaden the scope of the act, the committee has included it in this bill." H. Rep. No. 709, 75th Cong., 1st Sess., 3 (1937).

FPC v. Louisiana Power & Light Co., 406 U.S. at 637-38 n.14 (1972).

Clearly, then, the production and gathering exemption was intended to be a very narrow one. See also



Phillips Petroleum Co. v. Wisconsin, 347 U.S. at 679 (1954); Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 690-91 (1947); Northern Natural Gas Co. v. State Corp. Comm'n., 372 U.S. 84, 90 (1963) and the cases cited with approval therein. Moreover, this Court has already addressed the applicability of that exemption in a case which, all else aside, should be determinative of the question here. That case is United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965), which distinguished and severely limited the earlier holding of FPC v. Panhandle Eastern Pipe Line Co., 337 U.S. 498 (1949), upon which producers have relied so heavily throughout this litigation in an attempt to establish narrow limits on Commission authority. 35/ In United Gas Improvement, this Court rejected the argument that the Commission lacked jurisdiction over the sale, by a producer to an interstate pipeline, of leases covering proven and substantially developed reserves of gas dedicated to interstate commerce. The Court determined that the

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35/ See e.g., Brief of Respondent Producers in Opposition to Petitions for Writs of Certiorari, at 6; Brief of Respondents Tenneco Oil Company and Pennzoil Company in Opposition, at 3-8.

Commission's jurisdiction in that case rested on two factors: the leaseholds were substantially developed, and the sale of gas was in interstate, not intrastate, commerce. The same considerations apply in the instant case, since in enforcing certificated delivery obligations, the Commission is dealing with producers whose gas reserves are already dedicated pursuant to § 7, and already flowing in interstate commerce.

The wisdom of this Court's past approach in narrowly interpreting the § 1(b) exemption is illustrated by the present case, where an excessive reading, denying the Commission authority to enforce producer delivery obligations under an appropriate standard, would have practical consequences for both the Commission and the ultimate consumer of natural gas which would frustrate the underlying purposes of the Natural Gas Act. As the Court noted in a similar context, it would leave "[e]very independent producer of natural gas . . . free at a future date, untrammelled by Commission regulation, to reassess whether it desired to continue serving the interstate market." Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. at 142. See also California v. Southland Royalty Co., 98 S. Ct. at 1961. And, as a result, it would also place at severe



risk an elaborate system of investments and reliance which has been built upon certificated delivery obligations. 36/

How then could the court of appeals have upheld the producers' arguments? Although we do not agree that Order

36/ We assume the producers will make, as they did below, a number of subsidiary arguments, regarding the alleged absence of a regulatory gap and conflict with state law. We leave these arguments largely in the hands of the Commission. Suffice it to say that regulation of production and gathering activity by the producer state is hardly a practicable method for carrying out the unique mandate of the Natural Gas Act. Cf. United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392, 403 (1965); Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 691 (1947). To this extent a "gap" surely exists. See FPC v. Louisiana Power & Light Co., supra, 406 U.S. at 631, 633, 634. Further, reliance on a checkerboard of varying state regulations could never bring about the comprehensive regulatory scheme contemplated by Congress. FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1, 28 (1961). Lastly, the present case involves no actual conflict between state and federal regulation, and even if it did, the (footnote continued)

539-B contravenes the 1(b) exemption, we nevertheless believe the answer to this question lies in the standard adopted in that Order. The standard reflects no attempt to inquire into the level of service a producer has provided in the past, so as to determine where and when there has been an unauthorized change or abandonment of service. Rather, the standard calls for a direct look at operations in the field, as the first order of business.

To the extent this approach is the source of a jurisdictional problem, it also points to the answer to that problem. By using a standard which looks first to service, the Commission would only need to consider field conditions if and when a producer argued that those conditions justified declining service from dedicated reserves. In this way, any Commission concern over production and

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(footnote continued)
Commission's jurisdiction would not necessarily give way. Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84 (1963).



gathering activity would be clearly incidental to the Commission's jurisdiction and authority over certificated service.

## CONCLUSION

For the reasons set forth above, the decision of the court of appeals should be reversed, and Order 539-B should be vacated and remanded to the Commission so that the Commission may develop a standard governing producer delivery obligations and an enforcement mechanism consistent with the requirements of the Natural Gas Act.

Respectfully submitted, */

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# APPENDIX A

## APPENDIX A

The Natural Gas Act, 15 U.S.C. § 717 et seq., provides in pertinent part:

§ 1(b) The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.
15 U.S.C. § 717(b).

§ 4(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order spec-

ifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.
15 U.S.C. § 717c(d).

§ 7(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.
15 U.S.C. § 717f(b).

§ 7(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations....
15 U.S.C. § 717f(c).



§ 7(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.
15 U.S.C. § 717f(e).

FOR ARGUMENT

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Nos. 77-1652 and 77-1654

# In the Supreme Court of the United States

OCTOBER TERM, 1978

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FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

*v.*

SHELL OIL COMPANY, ET AL.

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CONSUMER ENERGY COUNCIL OF AMERICA,
PETITIONER

*v.*

FEDERAL ENERGY REGULATORY COMMISSION

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

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## MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION AS RESPONDENT IN NO. 77-1654

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The brief of the Consumer Energy Council of America ("CECA")[1] as petitioner in No. 77-1654 addresses two questions. The first substantially overlaps the question presented by the Federal Energy Regulatory Commission as petitioner in No. 77-1652: Whether the "production or gathering" exclusion in Section 1(b) of the Natural Gas Act, 15 U.S.C. 717 (b), denies the Commission the authority to require certificated producers of natural gas to "observe the standard of a prudent operator" in developing and maintaining delivery of gas from their dedicated reserves.[2] CECA's second question (Br. 3) is based on its contention (Br. 27-50) that the "prudent operator" standard adcpted by the Commission does not constitute a proper measure for enforcing producer delivery obligations under certificates of public convenience and necessity. This memorandum is submitted by the Commission as respondent in No. 77-1654 in answer to this contention.

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[1] On November 27, 1978, the Court granted CECA's motion for substitution as successor to the Consumer Federation of America, Energy Policy Task Force. In this memorandum, "CECA" will designate both the original petitioner and its successor.

[2] The difference is that CECA states the question (Br. 2) in terms of the Commission's authority to enforce producers' delivery obligations "in accordance with an appropriate standard," rather than in accordance with the "prudent operator" standard adopted by the Commission in the order under review. This difference is subsumed in CECA's second question, discussed in the text.



CECA's second question was not ruled on by the court of appeals.[3] It therefore may not be ripe for consideration by this Court at this time. However, if the Court should choose to reach the question in the interest of judicial economy,[4] we submit that the Commission's decision should be affirmed.

The substance of CECA's argument is that the Commission's prudent operator standard "is not a service-oriented standard" (Br. 37) and that it is also vague and unenforceable (*id.* at 43). The argument reduces to the claim that the Commission, in exercising its rule-making authority toward an admittedly appropriate end, would have promoted that end more effectively by making a somewhat different rule from the one it made. Judicial acceptance of such a claim would invade the authority that Congress has given to the Commission. But assuming that a court may appropriately give substantive con-

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[3] The court stated (Pet. App. 10a n.6; emphasis in original):

> One final question raised concerns the "prudent operator" standard promulgated by Order No. 539-B. The argument is advanced that the "prudent operator" standard is inappropriate to FERC's goal to increase production of natural gas because "prudent operator" is a term of art employed in state regulations which are concerned with increasing the total recovery of hydrocarbons through the *conservation* of natural gas fields rather than permitting operators to waste energy resources by *exploitation* of reserves. We do not reach the issue due to our disposition on jurisdictional grounds.

[4] See, *e.g.*, *New Motor Vehicle Board of California* v. *Orrin W. Fox Co.*, No. 77-837 (December 5, 1978), slip op. 12 & n.13.

sideration to CECA's criticisms of the Commission's rule, those criticisms are unpersuasive.

1. In formulating the delivery obligations of producers in terms of the standard of a "prudent operator," the Commission was well within its statutory discretion. Order No. 539-B, establishing the prudent operator standard, constitutes a statement by the Commission of what the Natural Gas Act requires—an interpretation of the statute by the expert agency charged with its administration. As this Court has frequently stated, such an interpretation is entitled to considerable deference and ought to be accepted by a reviewing court if it is reasonable, whether or not the Commission might reasonably have chosen some other formulation of what the Act requires. See *Zenith Radio Corp.* v. *United States*, No. 77-539 (June 21, 1978), slip op. 7; *Train* v. *Natural Resources Defense Council*, 421 U.S. 60, 75 (1975).

In addition, the Commission's decision here represents its expert conclusion, based on its cumulative experience and knowledge of the natural gas industry, that the prudent operator standard will enable it to enforce the service obligation that the Act imposes on certificated natural gas companies. That conclusion is also entitled to great weight. See, *e.g.*, *Permian Basin Area Rate Cases*, 390 U.S. 747, 800 (1968); *FPC* v. *Natural Gas Pipeline Company*, 315 U.S. 575, 586 (1942). Cf. *NLRB* v. *Seven-Up Bottling Co.*, 344 U.S. 344, 349 (1953). As one court has stated with respect to the Commission's authority to structure



policies and remedies (*Niagara Mohawk Power Corp.* v. *FPC*, 379 F.2d 153, 159 (D.C. Cir. 1967)):

> * * * [T]he breadth of agency discretion is, if anything, at zenith when the action assailed relates primarily not to the issue of ascertaining whether conduct violates the statute, or regulations, but rather to the fashioning of policies, remedies and sanctions, including enforcement and voluntary compliance programs in order to arrive at maximum effectuation of Congressional objectives.

The Commission's power to adopt rules implementing service obligations under Sections 7 and 4 of the Natural Gas Act, 15 U.S.C. 717f and 717c, is based on Section 16 of the Act, which authorizes the Commission to issue "such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this Act." 15 U.S.C. 717*o*. If we are correct that the production or gathering exclusion in Section 1(b) does not bar adoption of a deliverability standard for dedicated gas (see the Commission's main brief)—a position with which CECA agrees—then the criteria embodied in the prudent operator standard are "based on permissible public interest goals and, so long as [they] are not an unreasonable means for seeking to achieve these goals, they fall within the general rulemaking authority recognized in [prior cases]."[6] *FCC* v. *National Citizens Committee for Broadcasting*, 436 U.S. 775, 796

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[6] See, *e.g.*, *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 776; *FPC* v. *Texaco Inc.*, 377 U.S. 33, 41 (1964).

(1978). Accord, *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council*, 435 U.S. 519, 543-544 (1978).[6]

2. CECA is incorrect in contending (Br. 37-43) that the prudent operator standard does not reflect the service obligation embodied in Section 7 of the Natural Gas Act. As we have explained in our opening brief, the Commission's rationale for promulgating the prudent operator standard was that once a producer obtains a certificate authorizing the sale of gas in interstate commerce (usually pursuant to a gas sales contract filed with the certificate application), the producer has a continuing statutory obligation to maintain that service of delivering gas in interstate commerce; the obligation is based on the certificate and on Section 7, and it supersedes any contractual provisions to the contrary. See Pet. App. 15a-24a; see also FERC Br. 21-30. The prudent operator standard is an appropriate and reasonable formulation of this service obligation.[7]

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[6] Moreover, even if CECA's attack on the effectiveness and enforceability of the Commission's standard were otherwise appropriate for judicial consideration, such consideration would be premature at this stage. The Commission has done no more than formulate and announce the standard. Because this initial action was held invalid by the court of appeals, steps to implement and enforce the standard necessarily have not been taken. And evidence concerning the standard's effectiveness and enforceability necessarily is not yet available.

[7] Accordingly, CECA's reliance on *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974) (Br. 41-42), is misplaced. In *Texaco*, the Court held that the Commission had used an affirmatively inappropriate standard by equating just and reasonable rates under the Act with prices of gas in the unregulated intrastate market. See 417 U.S. at 397-399. There is no basis for claiming that the prudent operator standard is similarly at odds with the basic purpose of the Act.



The standard is not vague and unenforceable, as CECA contends (Br. 43-50). Indeed, one of the reasons for adopting the standard was that it was consistent with requirements long established by leases and by state and federal regulatory agencies, so that "producers are very familiar with the requirements of this standard" (Pet. App. 16a). The Commission has chosen and defined the standard so it can be administered consistently with long-established state and federal production standards, so it will reflect the practical realities of gas reservoir mechanics,[8] and so at the same time it will ensure that producers do not default on their service obligations under the Natural Gas Act by failing to act with reasonable prudence.[9]

CECA is also wrong in claiming (Br. 46-50) that the standard is unenforceable. As the Commission noted (Pet. App. 23a):

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[8] See FERC Br. 32 n.19.

[9] Contrary to CECA's characterization (Br. 37-41), the Commission's standard does not call for a mechanical application either of leasing covenants or of state conservation requirements. Rather, it calls on producers to perform their delivery obligations in accordance with the concepts of prudent conduct that guide them in their daily operations. The Commission found, on the basis of a comprehensive rulemaking proceeding, that these concepts may be suitably adjusted to assure maintenance of deliverability under the Natural Gas Act. Pet. App. 19a, 20a.

> [T]he data necessary to facilitate any Commission action deemed necessary in implementing the instant order is either currently required to be filed by the appropriate persons or will be required as a result of our order implementing Form No. 108. More specifically, any information and materials submitted by virtue of Form No. 108, Form No. 15 and Form No. 40 will be used to assist the Commission and its Staff in enforcing certificated obligations.[10]

The Commission thus has available to it extensive information, furnished on a continuing basis, that will allow it to monitor changes in proved reserves and in the deliverability of those reserves. Any abnormal reduction in deliveries that is reported, com-

[10] Form No. 15 is required by 18 C.F.R. 260.7. This regulation requires natural gas pipelines to submit an annual report of gas supplies summarizing system deliverability, reservoir data, and remaining recoverable salable gas reserves; a delivery estimate for each supply source; and estimates of committed reserves and deliverability for other supply sources. These data are used by the Commission to "make a continuing review of gas reserves and deliverability of pipeline companies." 31 F.P.C. 750 (1964).

Form No. 40 is required by 18 C.F.R. 260.13. This regulation requires producers to furnish information concerning proved reserves, broken down by company, field, reservoir, and location. See Order No. 526-B, Docket No. RM74-16, issued June 30, 1977. The Commission has, however, postponed the effectiveness of Form No. 40 pending approval by the Office of Management and Budget. FERC Order No. 526-E, November 22, 1978.

Additional information is available to the Commission through Form No. 108, 18 C.F.R. 260.6, which identifies producing acreage by contract and location, actual delivery pressure, and BTU content.



plained of, or observed can be investigated, and the Commission can require the submission of additional information. Sections 10 and 14 of the Act, 15 U.S.C. 717i and 717m. Hence there is no reason to doubt that the prudent operator standard can be enforced. That other or even better standards might be developed does not render the Commission's invalid. *Vermont Yankee, supra,* 435 U.S. at 543-544; *FCC* v. *National Citizens Committee for Broadcasting, supra,* 436 U.S. at 803.

3. It is noteworthy that CECA, while criticizing the Commission's standard, at no point makes clear what alternative standard it believes the Commission should have adopted for defining producers' service obligations under the Act. CECA demands "a standard reflecting the Act's fundamental concern for maintenance of service," one "that is free from vagueness, and gives producers, consumers and Commission staff concrete guidance as to the supply obligations imposed by the Natural Gas Act" (Br. 26). But CECA declines to flesh out this abstract ideal. While CECA previously suggested that the Commission should impose some quantitative delivery requirement on each producer or should return to the standard originally proposed by the Commission in Order No. 539 (see Br. 15), CECA now offers only some unformed and tentative ideas (Br. 48-49), buttressed with assurances that "these problems are surely not insoluble," that "[a]pplying its expertise, the Commission should be able to develop a workable system of review * * *," and that "[c]learly, then, there are manageable solutions in the supply arena" (*ibid.*).

CECA, it appears, is now unwilling or unable to back up its criticism by proposing any specific alternative that it claims would be superior to the standard adopted by the Commission.[11]

4. If CECA still contends that the Commission must formulate a deliverability standard in terms of specific daily volumes of gas to be incorporated in each producer's certificate, the Commission reasonably declined to adopt such a formulation. As noted in our main brief (pages 6-12), the Commission initially, in Order No. 539, issued a declaration of policy stating that producers holding certificates under the Act had enforceable obligations with respect to the deliverability of "certificated volumes of natural gas supplies" (A. 11). Order No. 539 further provided that all certificates thenceforth issued should state a "certificated minimum daily delivery obligation of the seller" that would be derived from the gas sales con-

[11] CECA complains (Br. 42) that the Commission failed to investigate the producers' claims with respect to the nature of gas sales agreements and their production obligations under those agreements. However, CECA made no effort to demonstrate that these claims were unfounded or inaccurate. Instead, it confined itself to insistence that the Commission should impose fixed daily delivery obligations (A. 416-422). The Commission called for responses to questions, suggested by CECA, as to whether gas sales contracts contained specific delivery obligations (R. 451-465; A. 404). On the basis of these responses, the Commission found that it "must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers" (Pet. App. 12a). The Commission thus fully ventilated all questions raised by CECA.



tract but that would disregard any contrary contractual reservations (A. 12-13).

Producers protested Order No. 539 on the grounds, among others, that "certificated minimum daily delivery obligation" has no generally understood meaning among producers and that many gas sales contracts attached to Commission certificates do not provide for the delivery of any specific volume of gas per day. See A. 268. In response to such protests, the Commission instituted a rulemaking proceeding, considered written comments and oral arguments (A. 272), and on that basis concluded in Order No. 539-B that the term "certificated minimum daily delivery obligation * * * is not one that has a generally accepted meaning among pipelines and producers" (Pet. App. 12a). The Commission therefore declined to formulate a general deliverability standard in terms of specific volumes of gas, although it also stated that where a particular sales contract did call for the delivery of specific volumes, the producer's delivery obligations would be measured by those specific contract requirements (Pet. App. 15a). That decision was a reasonable one, and CECA advances no reasons for concluding otherwise.[12]

[12] If, as in a typical example, a producer applied for and obtained a certificate authorizing interstate sales pursuant to a contract with a pipeline that required the producer to sell to the pipeline all gas produced from a particular leasehold without specifying how much gas the producer was to produce or deliver on a daily basis, there would be obvious difficulties in quantifying the producer's statutory delivery obligation. CECA suggests no satisfactory method for doing so. Even if

## CONCLUSION

The Court need not reach the second question presented in No. 77-1654, but if it does reach that question, the Commission's order should be affirmed.

Respectfully submitted.

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JANUARY 1979

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some method could be conceived, this Court has consistently recognized that questions of administrative feasibility and enforcement are "matter[s] for the Commission to consider." *FPC* v. *Texaco Inc.*, 417 U.S. 380, 401 (1974).

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